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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1931

No. 270

THE PACIFIC CO., LTD., APPELLANT,

vs.

CHARLES G. JOHNSON, STATE TREASURER OF THE STATE OF CALIFORNIA

APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA

FILED JULY 31, 1931

(36,084)

(36,084)

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., SEPTEMBER 3, 1931

[fols. 1 & 2]

IN SUPREME COURT OF CALIFORNIA

Sac. No. 4500

THE PACIFIC CO., LTD., a Corporation, Appellant,

vs.

CHARLES G. JOHNSON, State Treasurer of the State of California, Respondent

Petition for Appeal, Assignment of Errors, and Prayer for Reversal—Filed June 18, 1931

PETITION FOR APPEAL

Considering itself aggrieved by the final decision of the Supreme Court of the State of California in the above entitled cause, the plaintiff therein, The Pacific Co., Ltd., hereby prays that an appeal be allowed to the Supreme Court of the United States, herein, and for an order fixing the amount of the bond thereon.

ASSIGNMENT OF ERRORS

And the said The Pacific Co., Ltd., assigns the following errors in the record and proceedings in the said case:

1. The Supreme Court of the State of California erred in deciding that the provisions of the Bank and Corporation Franchise Tax Act (California Statutes 1929, Chapter 13, Page 19), in so far as it declares and attempts to make taxable, income derived from bonds of improvement districts of the State of California held by the petitioner, which bonds were issued prior to November 6, 1928, under the provisions of Article 1 3/4, Section 13 of the Constitution of the State of California, providing that said bonds "shall be free and exempt from taxation", are not in viola-
[fol. 3] tion of Section 10 of Article I of the Constitution of the United States as impairing the obligation of contracts.

2. The Supreme Court of the State of California erred in deciding that the provisions of the Bank and Corpora-

tion Franchise Tax Act (California Statutes 1929, Chapter 13, Page 19), in so far as it declares and attempts to make taxable, income derived from bonds of improvements districts of the State of California, held by the petitioner, which bonds were issued prior to November 6, 1928, under the provisions of Article 1 3/4, Section 13, of the Constitution of the State of California, providing that said bonds "shall be free and exempt from taxation", are not in violation of Article XIV, Section 1 of the Articles in addition to and amendment of the Constitution of the United States as depriving the petitioner of its property without due process of law, and denying to it the equal protection of the law.

3. The Supreme Court of the State of California erred in deciding that the Legislature of the State of California by the enactment of the Bank and Corporation Franchise Tax Act (California Statutes 1929, Chapter 13, Page 19), was not attempting by indirection to levy a tax upon bonds of the improvement districts of the State of California, held by the petitioner, which bonds were issued prior to November 6, 1928, under the provisions of Article 1 3/4, Section 13 of the Constitution of the State of California, providing that said bonds "shall be free and exempt from taxation."

PRAYER FOR REVERSAL

For which errors the plaintiff, The Pacific Co., Ltd., prays that the said judgment of the Supreme Court of the State of California, dated May 1, 1931, in the above entitled cause, be reversed and a judgment rendered in favor of the said plaintiff, and for costs.

Dated June 16, 1931.

Joseph D. Peeler, Joseph D. Peeler, Melvin D. Wilson, Melvin D. Wilson, Counsel for Appellant.

[fol. 3½] [File endorsement omitted.]

[fol. 4] IN SUPREME COURT OF CALIFORNIA

[Title omitted]

ORDER ALLOWING APPEAL—Filed June 18, 1931

The appellant in the above entitled suit, having prayed for the allowance of an appeal in this cause to the Su-

preme Court of the United States from the judgment made and entered in the above entitled suit by the Supreme Court of the State of California on the first day of May, 1931, and from each and every part thereof, and having presented and filed their petition for appeal, assignment of errors, and prayer for reversal, pursuant to the statutes and the rules of the Supreme Court of the United States in such case made and provided:

It is now here ordered that an appeal be, and the same is hereby, allowed to the Supreme Court of the United States from the Supreme Court of the State of California in the above entitled cause, as provided by law, and it is further ordered that the Clerk of the Supreme Court of the State of California shall prepare and certify a transcript of the record, proceedings and judgment in this cause and transmit the same to the Supreme Court of the United States, so that he shall have the same in said Court within sixty days of this date.

And it is further ordered that security for costs on appeal be fixed in the sum of $500.00.

Dated June 18th, 1931.

Emmet Seawell, Acting Chief Justice of the Supreme Court of the State of California.

[File endorsement omitted.]

[fol. 5] IN SUPREME COURT OF CALIFORNIA

[Title omitted]

CLERK'S CERTIFICATE

I hereby certify that Associate Justice Emmet Seawell, the senior justice of this Court is, in accordance with the rules of this Court, made and adopted by this Court on September 2, 1926, the acting Chief Justice of said Court, and since Monday, June 15, 1931, has been such acting Chief Justice in the place and stead of the Honorable William H. Waste, who is now and since the day last above named has been absent from the state of California, and that said Acting Chief Justice Emmet Seawell is fully

authorized to act in the place and stead of said Chief Justice William H. Waste in all matters arising in said Court as fully as said Chief Justice may have acted if personally present.

B. Grant Taylor Clerk of Supreme Court, by I. Erb, Chief Deputy. (Seal.)

Dated June 23, 1931.

[fols. 6 & 7] Bond on appeal for $500.00, approved and filed June 26, 1931, omitted in printing.

[fols. 8 & 9] Citation, in usual form, showing service on U. S. Webb, filed June 18, 1931, omitted in printing.

[fol. 10] IN SUPREME COURT OF CALIFORNIA

[Title omitted]

PRÆCIPE FOR TRANSCRIPT OF RECORD—Filed June 26, 1931

To the Clerk of the Supreme Court of the State of California:

You are hereby requested to make a transcript of the record of this cause to be used in an appeal to the Supreme Court of the United States, the transcript to consist of the record on appeal in said cause, including the pleadings; the decision and the remittitur, besides copies of the petition for appeal, the assignment of errors, prayer for reversal, order of court allowing appeal, bond and citation, and copies of opinions of the Court, the counsel for the appellant deeming the above portions of the record to be material to and necessary for a decision of the questions involved.

Respectfully, Miller, Chevalier, Peeler & Wilson, by Joseph D. Peeler, by Melvin D. Wilson.

Dated: June 24, 1931.

[fol. 11] UNITED STATES OF AMERICA,
State of California,
County of ——:

Due and sufficient service of the within Præcipe is hereby accepted this — day of June, 1931.

Charles G. Johnson, State Treasurer of the State of California, (Signed) by H. H. Linney, Deputy Attorney General.

[fol. 11½] [File endorsement omitted.]

———

[fol. 12] [File endorsement omitted]

IN SUPERIOR COURT OF SACRAMENTO COUNTY

No. 45001

THE PACIFIC CO., LTD., a Corporation, Plaintiff,

vs.

CHARLES G. JOHNSON, State Treasurer of the State of California, Defendant

Recovery of Corporation Franchise Taxes Illegally Collected

AMENDED COMPLAINT—Filed Aug. 18, 1930

Comes now the plaintiff and for its amended cause of action alleges:

First Cause of Action

I

Plaintiff is and during all the time hereinafter mentioned was a California corporation, having its principal office in the Pacific Finance Building, 621 South Hope street, Los Angeles, California. Plaintiff was at the time of filing its franchise tax return, as hereinafter mentioned, called The Elliott Horne Co., but has changed its name to The Pacific Co., Ltd., under the procedure required by law for the change of corporate names.

II

Defendant is, and during all of the times hereinafter mentioned has been, state treasurer of California, and has his office and residence in Sacramento, Sacramento county, California. This action is brought against defendant as an officer acting under and by virtue of the Bank and Corporation Franchise Tax Act of California.

III

Plaintiff having applied for and received an extension to August 15, 1929, for filing its franchise tax return for the taxable period ended December 31, 1928, filed a franchise [fol. 13] tax return on August 10, 1929, under Article XIII, section 16 of the Constitution of California, and Statutes 1929, chap. 13, and paid to the defendant, for the privilege of doing business in corporate form throughout the calendar year 1929, taxes, interest and penalties as follows:

Date	Tax	Interest	Penalty	Totals
August 10, 1929 ...	$2,509.24	$37.64	.....	.....
Nov. 18, 1929	2,509.24	52.70	$125.46	.....
	$5,018.48	$90.34	$125.46	$5,234.28

IV

Included in the income upon which that tax was based was, as required by section 6 of the Bank and Corporation Franchise Tax Act, the amount of $651,732.75 profits received by plaintiff upon the purchase and sale of bonds issued prior to November 6, 1928, by various improvement districts, organized and existing under the laws of the state of California.

V

Article I, section 10 of the Constitution of the United States prohibits any state from passing a law which would impair the obligation of contracts. Articles XII, section 1 3/4 of the Constitution of California, provides that bonds issued by municipal corporations and improvement districts shall be exempt from taxation. Article I, section 16 of the Constitution of California, provides that no law impairing the obligation of contracts shall ever be passed.

VI

While all of the constitutional provisions mentioned above were in effect, and prior to November 6, 1928, the bonds in question were issued by various improvement districts in California. The issuance of these bonds, while the above-mentioned constitutional provisions were in ef-
[fol. 14] fect, constituted a contract between the state of California and the various improvement districts with the buyers of the bonds, that the bonds would be exempt from taxation.

VII

Plaintiff purchased certain of the said bonds of and from the California improvement districts, and, during the taxable year ended December 31, 1928, resold the same at profits totalling $651,732.75.

VIII

Plaintiff purchased the said bonds in sole reliance on the constitutional contract that the bonds and the income therefrom would, in accordance with the constitutional provisions, be entirely exempt from taxation.

IX

The Bank and Franchise Tax Act, section 6, required plaintiff to report as income, upon which the tax was based, the profits on the bonds, and plaintiff paid the tax measured by the said profits.

X

The imposition of the tax measured by the profit on the purchase and sale of such bonds constituted a tax on the bonds themselves.

XI

The taxation of the bonds by the state of California, after they had been issued under a contract that they would be exempt from taxation in California, impairs the obligation of that contract, and is void under article I, section 10 of the Constitution of the United States and under art. 1, sec. 16 of the Constitution of California.

XII

The elimination from gross income of the $651,732.75 profits on the purchase and sale of the improvement bonds [fol. 15] would eliminate the entire amount of taxable net income reported on the return, namely, $140,345.02.

XIII

The elimination of the taxable income entitled plaintiff to a refund of the tax, penalties and interest paid, except for the minimum tax of $25.00 as provided by section 4 of the Bank and Franchise Tax Act.

XIV

On June 9, 1930, plaintiff, in accordance with the law, filed with the Franchise Tax Commissioner of the state of California, its claim for refund of all tax, interest and penalties mentioned above, with the exception of the $25.00 minimum tax, namely, $4,993.48 tax, $125.46 penalty, and interest on said amounts.

XV

The basis of the claim for refund was the same as is stated in this amended complaint, namely, that the imposition of the tax on the profit from the purchase and sale of the bonds issued by the various improvement districts of California, amounted to the impairment of the obligation of the contract existing under the constitutional provisions mentioned herein, and was void.

XVI

The Franchise Tax Commissioner duly rejected the claim for refund on June 17 and/or July 7, 1930.

XVII

The claim for refund is the property of plaintiff and has not been assigned or transferred to any person, firm, or corporation.

[fol. 16] Second Cause of Action

I

Plaintiff refers to paragraphs I, II, III, V, VI, XI and XVII of the first cause of action and by reference incor-

porates them herein as if they were fully set forth in this second cause of action.

II

On March 17, 1930, the Franchise Tax Commissioner of the state of California mailed his notice of proposed assessment of additional franchise tax for the year ended December 31, 1928, of $6,692.96, plus interest at 6 per centum from the time *the time* the alleged tax was due. The basis of the proposed assessment was the inclusion in the tax base by the commissioner of $167,324.11 interest received by plaintiff in the calendar year 1928 from bonds issued (prior to November 6, 1928) by various improvement districts organized and existing under the laws of the state of California. The said interest was required by section 6 of the Bank and Corporation Franchise Tax Act to be included in income for the purpose of computing the tax.

III

On March 21, 1930, the plaintiff in the form required by the statute, protested the proposed assessment on the ground that the bonds and the interest on the bonds were exempt from taxation in California under the constitutional provisions mentioned above.

IV

On May 29, 1930, the commissioner notified plaintiff of his final action in the matter, which affirmed his proposed assesment. The commissioner's final notice demanded an additional tax of $6,692.96, plus interest.

V.

On June 6, 1930, plaintiff, under protest, paid the said tax and interest to the defendant. The grounds of protest [fol. 16½] were the same as set forth in the prior protest and the same as are set forth in this second cause of action.

VI

Plaintiff purchased the said bonds (issued prior to November 6, 1928) of and from the various improvement dis-

tricts, solely in reliance on the contract that the bonds and the income therefrom would, in consonance of the said constitutional provisions, be entirely exempt from taxation.

VII

The tax measured by the interest received from the said bonds amounts to a tax on the bonds themselves, and is in violation of article I, section 10 of the Constitution of the United States and article I, section 16 of the Constitution of California, void.

Third Cause of Action

I

Plaintiff refers to paragraphs I, II, III, V and XVII of the first cause of action, and to paragraphs III, V and VII of plaintiff's second cause of action, and by reference incorporates them herein as if they were fully set forth in this third cause of action.

II

While all of the constitutional provisions mentioned above were in effect, and after November 6, 1928, the bonds in question were issued by various improvement districts in California. The issuance of these bonds while the above-mentioned constitutional provisions were in effect, constituted a contract between the state of California, the various improvement districts, and the buyers of the bonds, that the bonds would be exempt from taxation.

III

On March 17, 1930, the franchise tax commissioner of [fol. 17] the state of California mailed his notice of proposed assessment of additional franchise tax for the year ended December 31, 1928, of $104.95, plus interest at 6 per centum from the time the alleged tax was due. The basis of the proposed assessment was the inclusion in the tax base by the commissioner of $2,624.07 interest received by plaintiff in the calendar year 1928 from bonds issued after November 6, 1928, by various improvement districts organized and existing under the laws of the state of California. The said interest was required by section 6 of the Bank and

Corporation Franchise Tax Act to be included in income for the purpose of computing the tax.

IV

On May 29, 1930, the commissioner notified plaintiff of his final action in the matter, which affirmed his proposed assessment. The commissioner's final notice demanded an additional tax of $104.95, plus interest for the taxable year ended December 31, 1928.

V

Plaintiff purchased the said bonds issued after November 6, 1928, of and from the various improvement districts, solely in reliance on the contract that the bonds and the income therefrom would, in consonance of the said constitutional provisions, be entirely exempt from taxation.

Wherefore plaintiff prays for judgment against the defendant as follows:

First Cause of Action

Original tax, $2,484.24, plus interest at 6% from March 15, 1929.

Original tax, $2,509.24, plus interest at 6% from Septem-
[fol. 18] ber 15, 1929.

Penalty, $125.46, plus interest at 6% from September 15, 1929.

Second Cause of Action

Additional tax, $3,346.48, plus interest at 6%, from March 15, 1929.

Additional tax, $3,346.48, plus interest at 6%, from September 15, 1929.

Third Cause of Action

Additional tax, $52.48, plus interest at 6%, from March 15, 1929.

Additional tax, $52.47, plus interest at 6%, from September 15, 1929, together with costs of suit.

Miller, Chevalier, Peeler & Wilson by Melvin D. Wilson, Attorneys for Plaintiff.

Duly sworn to by F. S. Baer. Jurat omitted in printing.

[File endorsement omitted.]

[fol. 19] IN SUPERIOR COURT OF SACRAMENTO COUNTY

DEMURRER TO AMENDED COMPLAINT—Filed Aug. 28, 1930

Comes now Charles G. Johnson, as treasurer of the state of California, defendant herein, and answering plaintiff's amended complaint, demurs thereto and for grounds of demurrer says:

I

That said amended complaint does not state facts sufficient to constitute a cause of action against said defendant.

Wherefore defendant prays that said action be dismissed and for his costs herein expended.

U. S. Webb, Attorney General of the State of California; H. H. Linney, Deputy Attorney General; Albert F. Zangerle, Deputy Attorney General, Attorneys for Defendant.

[File endorsement omitted.]

[fol. 20] IN SUPERIOR COURT OF SACRAMENTO COUNTY

THE PACIFIC COMPANY, LTD., Plaintiff,

vs.

CHARLES G. JOHNSON, etc., Defendant

ORDER SUSTAINING DEMURRER—Sept. 8, 1930

The demurrer to the complaint in the above entitled cause came on regularly this day for hearing. Miller, Chevalier and Peeler, counsel for plaintiff, and U. S. Webb, attorney general of the state of California, —— ——, deputy attorney general, appearing in court.

Thereupon said demurrer was partially argued to court by counsel for respective parties, and the court upon its own motion, and counsel for respective parties consenting thereto orders that the demurrer in the above entitled cause be and the same is hereby sustained without leave to amend.

IN SUPERIOR COURT OF SACRAMENTO COUNTY

NOTICE OF APPEAL FROM JUDGMENT—Filed Sept. 8, 1930

Notice is hereby given that plaintiff in the above-entitled action does hereby appeal to the Supreme Court of the state of California from that certain judgment heretofore and on or about the 8th day of September, 1930, made and entered therein, in said Superior Court, in favor of the defendant in said action and against said plaintiff, and from the whole thereof.

Dated September 8th, 1930.

Miller, Chevalier, Peeler & Wilson, by Melvin D. Wilson, Attorneys for Plaintiff.

[File endorsement omitted.]

[fol. 21] IN SUPERIOR COURT OF SACRAMENTO COUNTY

NOTICE TO COUNTY CLERK FOR PREPARATION OF TRANSCRIPT ON APPEAL AND FROM JUDGMENT—Filed Sept. 8, 1930

To the County Clerk of the County of Sacramento, State of California, and ex-officio Clerk of the above-entitled Superior Court:

You will please take notice that plaintiff in the above-entitled action desires and intends to appeal to the Supreme Court of the state of California from the judgment heretofore and on or about the 8th day of September, 1930, made and entered in the above-entitled court and action in favor of the above-named defendant, and against the said plaintiff, and from the whole of said judgment, and that pursuant to the provisions of section 953-A of the Code of Civil Procedure said plaintiff does hereby request that a transcript be made up and prepared of the papers used in said action, wherein and as a result of which said trial said judgment was made and entered, and of any and all other proceedings of any kind at said trial and of any and all notices, papers, pleadings, records, proceedings or orders filed, had or made with reference thereto. Such transcript to be made up and prepared as the transcript on appeal

from said judgment in accordance with the provisions of section 953-A of the Code of Civil Procedure.

You are further hereby requested to prepare a clerk's transcript for use on said appeal from said judgment which shall contain each and all of the papers, matters and things required by sections 950 and 951 of the Code of Civil Procedure to be furnished on appeal from a final judgment.

You are advised that said plaintiff has arranged with the stenographic reporter for his compensation.

Dated September 8th, 1930.

Miller, Chevalier, Peeler & Wilson, by Melvin D. Wilson, Attorneys for Plaintiff.

[File endorsement omitted.]

[fol. 22] Clerk's certificate to foregoing transcript omitted in printing.

[fols. 23 & 23½] In Superior Court of Sacramento County

Suit No. 45001. Decree No. 25476

Decree Entered Oct. 14, 1930, at 2:15 o'clock p. m., Nunc pro tunc. Sep. 8, 1930

Judgment—Filed Oct. 14, 1930

Judgment for Defendant

This cause coming regularly on for hearing this 8th day of September, 1930, by the court, upon defendant's demurrer to plaintiff's amended complaint, and the court having heard the arguments thereon and the matter being submitted for decision.

It is ordered, adjudged and decreed that defendant's demurrer to plaintiff's amended complaint be and the same is hereby sustained without leave to amend, and judgment is hereby rendered nun pro tunc in accordance with the stipulation of both parties on file herein in favor of the

defendant and that plaintiff take nothing by its said action and that defendant recover his costs.

Done in open court this 14th day of October, 1930.

John F. Pullen, Judge of the Superior Court.

Attest: Harry W. Hall, Clerk, by Wm. H. Dick, Deputy Clerk. (Seal.)

[File endorsement omitted.]

[fol. 24] IN SUPREME COURT OF CALIFORNIA

In Bank

Sac. No. 4500

THE PACIFIC CO., LTD. (a Corporation), Plaintiff and Appellant,

v.

CHARLES G. JOHNSON, State Treasurer of the State of California, Defendant and Respondent

[1] Taxation—Corporations—Franchises—Conditions.—In granting a franchise to a corporation, the state may limit the powers to be exercised under it, annex conditions to its enjoyment, and require the corporation to contribute to the revenues of the state.

[2] Id.—Franchises—Property.—A franchise tax is a tax imposed upon a corporation for the right or privilege of being a corporation or of doing business in a corporate capacity, and differs materially from property taxes as levied for state and municipal purposes in the basis prescribed for computing the amount of the tax, and where a tax is lawfully imposed upon the exercise of privileges within the taxing power of the state or nation, the measure of such tax may be the income from the property of the corporation, although a part of such income is derived from property in itself nontaxable.

[3] Id.—Corporations—Banks and Banking—Franchises—Constitutional Law.—The Bank and Corporation

Franchise Tax Act (Stats. 1929, p. 19), which provides for and requires the inclusion of interest from "federal, state, municipal or other bonds" in the net income base by which the state franchise tax of banks and corporations is measured, provides only for a franchise tax and not a tax on the property held by banks or corporations, and it is not, therefore, in violation of section 1¾ of article XIII of the state Constitution exempting from taxation all bonds issued by the state, or any county, city and county, municipal corporation or district thereof, nor in violation of the provisions of the state and federal constitutions forbidding the state to pass any law impairing the obligation of contract, and the fact that a portion of the net income upon which the franchise tax is based may be from property which is itself nontaxable is immaterial.

[4] Id. — Bonds — Sale of — Profits—Exemptions.—Although federal, state and municipal bonds may be exempt from direct taxation, profits derived from the purchase and sale of such securities are to be included in the net income of a corporation or bank which is used as a basis for determining the amount of the state franchise tax under the Bank and Corporation Franchise Tax Act (Stats. 1929, p. 19).

Appeal by plaintiff from a judgment of the Superior Court of Sacramento County, John F. Pullen, Judge, in an action to recover taxes paid under protest. Affirmed. Langdon, J., dissents.

For Appellant: Miller, Chevalier, Peeler & Wilson; Melvin D. Wilson.

For Respondent: U. S. Webb, Attorney-General; H. H. Linney, Deputy Attorney-General; Frank L. Guerena, of Counsel.

OPINION—March 31, 1931

Plaintiff seeks to recover certain taxes paid under protest and alleged to have been unconstitutionally exacted. Defendant's general demurrer to the complaint was sustained without leave to amend. From the judgment thereafter entered plaintiff prosecuted this appeal, urging the invalidity of those portions of the Bank and Corporation

Franchise Tax Act (Stats. 1929, chap. 13, p. 19), which provide for and require the inclusion of interest from "federal, state, municipal or other bonds" in the net income base by which the state franchise tax of banks and corporations is measured. The importance, both to the taxing power and the taxpayer, of a proper determination of this issue prompts us to briefly review the history of state taxation, in order that a complete understanding may be had of the origin of the statute here assailed, the principles underlying it, and the legal and economic factors that made imperative its enactment. The materiality of such investigation will subsequently appear.

Prior to 1910, state revenues were derived mainly from a direct ad valorem property tax levied upon all taxable [fol. 25] property within the state. Under this system, corporate property was subject to both state and county levies, and in time the method was found to be unsatisfactory, burdensome, and, in some cases, inequitable. (Pacific G. & E. Co. v. Roberts, 168 Cal. 420, 423, 143 Pac. 700.) This led to the creation of a commission whose task it was to study the situation and suggest a remedy. The plan proposed by this commission was adopted in 1910 (sec. 14 of art. XIII, Const.), and certain corporations were thereupon placed in a class apart and their franchises taxed exclusively for state purposes. Under this constitutional amendment and the several legislative acts passed pursuant thereto, the state tax on public utilities was determined by a percentage of their gross earnings; that on insurance companies by a percentage of their gross premiums; that on banks (national and state) by a percentage of their capital, surplus and undivided profits; and that on other corporations by a percentage of the "actual cash value" of their franchises. This system of taxation was not seriously challenged until the year 1927, when a crisis in bank taxation became acute. The reason for this difficulty is traceable to the fact that national banks, as instrumentalities of the federal government, are taxable by the states only with the authority of congress, and within the limits prescribed by that body. Until 1864 no provision was made for state taxation of national banks. In 1868 congress enacted, and has amended from time to time,

section 5219 of the Revised Statutes, setting out the methods by which national banks may be taxed, and the limitations within which the local taxing bodies may act. When California adopted its 1910 method of taxing banks, utilities and other corporations, section 5219 permitted, as reflected in our law as it then read, only one form of levy on national banks, viz., a tax on shares. The right to levy such tax was subject to two conditions, namely, (1) the rate could not be higher than that assessed in the state levying the tax upon other moneyed capital in the hands of individual citizens; and (2) the tax was to be in lieu of all other state, county or municipal charges except taxes on real property. This single authorized method of levy on national banks led to the growth of a more or less uniform system of taxation on these institutions throughout the country; that is to say, the combined value of capital, surplus and undivided profits was made the base of the tax, and the local rate was applied.

In time, however, difficulty with this method of taxing national banks arose because of the limitation that the rate of tax on national bank shares should not be in excess of that assessed upon other moneyed capital in competition with banks. The judicial history of section 5219, supra, has been written around attempts of the courts to explain the key words, "other moneyed capital in the hands of individual citizens". In 1921, the Supreme Court of the United States declared the Virginia tax on national banks invalid because it violated this provision. (Merchants Nat. Bank v. City of Richmond, 256 U. S. 635.) This decision was promptly used by national banks throughout the country to test the validity of the various laws under which they were being taxed. The existence of these and other conditions led to the amendment of section 5219, supra, in 1923, and again in 1926. Under this latest amendment, and as the section now reads, the states are authorized, subject to certain conditions, to (1) tax the shares of national banks to their owners; or (2) include the dividends therefrom in the taxable income of the owners or holders thereof; or (3) tax the banks on their net income; or (4) tax the banks according to or [fol. 26] measured by their net income. The section further provides that in the case of a tax according to or

measured by net income, the taxing state may "include the entire net income received from all sources", but the rate shall not be higher than the rate assessed upon state banks or other corporations. The states of New York, Massachusetts, Wisconsin, Oregon, and Washington were quick to take advantage of the authority given by this amendment of section 5219, supra, and state statutes imposing "franchise" taxes on national banks and other financial and business corporations, and measured by or according to their net income were enacted.

Examination of the final (1929) report of the California tax commission (California State Printing Office Publication No. 63725) discloses that that commission, after an extended and careful study of the state taxing situation, concluded that there was immediate and dire need for a change in the method by which banks and corporations were being taxed in this state. As intimated in the report, this conclusion was prompted in part by certain decisions of the United States Supreme Court (First National Bank v. City of Hartford, 273 U. S. 548; State of Minnesota v. First National Bank, 273 U. S. 561) interpreting the phrase, "other moneyed capital in the hands of individual citizens", appearing in section 5219, supra, and by the decision of this court in validating the Solvent Credits Acts of 1925 and 1927. (Arnold v. Hopkins, 203 Cal. 553, 265 Pac. 223.) The report of the commission states, in part: "Under the interpretation of the existing federal statute [sec. 5219] the method of taxing banks now in force in this state can apparently be maintained only at the sacrifice of the special treatment of intangibles, which is greatly desired by the public, and at the cost of the taxation of mortgages. There is no assurance that the Congress will extend further the state's power to tax banks and the commission believes that mortgages should not be taxed. Consequently some new method of taxing banks must be sought." It was estimated that if the crisis caused by the federal decisions and the existing condition of the state taxing system were not met by an immediate constitutional amendment and legislative enactment, the state would be faced with the likely loss of all revenue from banks beginning with the fiscal year July 1, 1926—a loss, if suffered, of approximately $22,000,000. The tax commission thereupon concluded "that the only practicable method of securing a sub-

stantial revenue from the banks is to proceed under the fourth method permitted by the federal statute, and tax banks 'according to or measured by net income'". Under this method, it was stated, "the state may continue to exempt real estate mortgages and may enact a solvent-credits law without danger of invalidating the bank tax." It was therefore recommended to the governor that a special session of the legislature be called to consider the submission to the people of an amendment to the state Constitution providing for a tax on banks "according to or measured by their net income." Pursuant to this suggestion, and in response to a call from the governor, the legislature met in special session on September 4, 1928, and on the following day voted to submit to the people an amendment authorizing this new method for taxing banks and other corporations and providing for the taxation of intangibles. The proposed amendment (sec. 16, art. XIII, Const.) was adopted by popular vote at the general election on November 6, 1928. It provides that "Notwithstanding any other provision of the Constitution", banks, including national banking associations, and all financial, [fol. 27] mercantile, manufacturing and business corporations shall annually pay to the state a tax to be measured by or according to their net income, and that the legislature may define net income "to be the entire net income received from all sources."

In conformity with the provisions of this constitutional amendment the legislature at its regular session in 1929, enacted the California Bank and Corporation Franchise Tax Act, supra, the validity of which is now brought into question. This statute is the first departure from the general theory that property should be the fundamental test of the adequacy of all business taxation in California. In so far as material here, the act provides, in substance:

Section 1. Every national bank located within this state shall annually pay to the state a tax according to or measured by its net income to be computed at the rate of four per cent upon the basis of its net income for the next preceding fiscal or calendar year;

Section 2. Every bank, other than a national bank, doing business within this state, shall annually pay to the state "for the privilege of exercising its corporate franchises

within this state", a tax according to or measured by its net income, to be computed at the rate of four per cent upon the income for the next preceding fiscal or calendar year;

Section 4. Every financial, mercantile, manufacturing and business corporation, doing business within this state, shall annually pay to the state, "for the privilege of exercising its corporate franchises within this state", a tax according to or measured by its net income, to be computed at the rate of four per cent upon its net income for the next preceding fiscal or calendar year;

Section 6. The term "gross income" includes, among other things, "all interest received from federal, state, municipal or other bonds".

Section 7. The term "net income" means the gross income less the deductions allowed, no deduction being allowed for interest received from federal, state, municipal or other tax exempt bonds.

As intimated at the commencement of this opinion, it is the appellant's contention that the act is unconstitutional and void in so far as it attempts to include interest from tax-exempt bonds in the tax base. In support thereof, reliance is placed by appellant on section 1¾ of article XIII of the state Constitution exempting from taxation all bonds issued by the state, or any county, city and county, municipal corporation or district thereof, and on section 10 of article I of the federal Constitution and sect[illegible] of article I of the state Constitution forbidding the [illegible]te to pass any law impairing the obligation of contracts. In short, appellant urges that to permit the state to include interest from tax-exempt bonds in the tax base is to permit it to do indirectly what it cannot do directly. The attorney-general replies that it has been consistently held by the United States Supreme Court that either the federal government or a state government "may legally impose a franchise tax upon corporations for the right to exercise their corporate privileges, measured in amount by a percentage of net income although a portion of the income is derived from property which in itself is nontaxable, the court stating that the distinction lies between the attempt to tax the property as such and to measure a legitimate tax upon the privileges involved in the use of such property".

[1] It is settled, of course, that in granting a franchise to a corporation the state may limit the powers to be exer- [fol. 28] cised under it, annex conditions to its enjoyment, and require the corporation to contribute to the revenues of the state. (Home Ins. Co. v. New York, 134 U. S. 594.)

[2] A franchise tax is a tax imposed upon a corporation for the right or privilege of being a corporation or of doing business in a corporate capacity, and differs materially from property taxes as levied for state and municipal purposes in the basis prescribed for computing the amount of the tax. The doctrine of the taxability of corporate franchises, without reference to the character of the property in which their capital stock or their deposits are invested, has long since been established. (Society for Savings v. Coite, 73 U. S. 594; Prov. Inst. v. Mass., 73 U. S. 611.) Accordingly, it was early held that "where a tax is lawfully imposed upon the exercise of privileges within the taxing power of the state or nation, the measure of such tax may be the income from the property of the corporation, although a part of such income is derived from property in itself nontaxable". (Flint v. Stone Tracy Co., 220 U. S. 107, 163.) The cited case is principally relied on by the attorney-general as establishing the constitutionality of the act here under consideration. This doctrine, that the taxing power may with propriety include within a franchise tax base the interest received from tax exempt bonds, while never expressly overruled, seemed to have been greatly narrowed and restricted in its application by the decision in Macallen v. Massachusetts, 279 U. S. 260, decided by a divided court on May 27, 1929; but it must be noted that, in deciding in that case that the Massachusetts franchise tax act was unconstitutional, in so far as it purported to include in the tax base interest from tax-exempt securities, the Supreme Court did not see fit to overrule its decision in Flint v. Stone Tracy Co., supra, and the dissenting minority of the court, per Mr. Justice Stone, said: "There is no constitutional principle and no decision of this court, of which I am aware, which would deny to the state the power so to tax the privileges which it has conferred upon petitioner, even though all its property were tax-exempt securities of the United States and income derived from them. For seventy years this court has consistently adhered to the principle that either the federal or state governments

may constitutionally impose an excise tax on corporations for the privilege of doing business in corporate form, and measure the tax by the property or net income of the corporation, including the tax-exempt securities of the other or income derived from them. Provident Institution v. Massachusetts, [6 Wall. 611] supra; Society for Savings v. Coite, 6 Wall. 594; Hamilton Co. v. Massachusetts, [6 Wall. 632] supra; Home Insurance Co. v. New York, 134 U. S. 594; Flint v. Stone Tracy Co., 220 U. S. 107, 162-5. In Flint v. Stone Tracy Co., a federal tax on corporations 'with respect to carrying on or doing business' measured by net income, was held to be an excise, not a direct tax on property or income, and so was valid, although not apportioned under art. I, sec. 2, cl. 3, sec. 9, cl. 4 of the Constitution and notwithstanding the fact that net income from tax-exempt municipal bonds was included in the measure of the tax. In no technical sense does this tax seem open to objection. Being an excise the tax is not one on property or income and may include either in its measurement although not directly taxable."

If the Macallen case raised any doubt, the question seems to be now definitely settled. When this case now before us was submitted, there was pending in the United States [fol. 29] Supreme Court a case, Educational Films Corporation of America v. Ward, Atty. General of New York et al., which was an action to restrain the collection of a tax levied under the New York tax law which lays an annual tax on every domestic corporation of certain classes "for the privilege of exercising its franchise in [that] state in a corporate or organized capacity". The tax, payable in advance for each year, is at the rate of 4½ per cent of so much of the corporation's "entire net income" for the preceding fiscal year as is allocated to the business carried on within the state. Such "net income" embraces "income from any source", and "is presumably the same as the entire net income which such corporation is required to report to the United States, plus any income received as dividends on stocks or any interest received" from federal, state, municipal or other bonds. Subdivision 3 of section 208 of the Act provides: "The term 'entire net income' means the total net income, including all dividends received on stocks and all interest received from federal, state, municipal or other bonds * * *." The Films

Corporation was the owner of certain copyrights granted by the United States upon motion picture films, and had received royalties from the licensing of them. It challenged the tax assessed against it under the New York statute, supra, so far as it was measured by the amount of these royalties, because it was to that extent, it claimed, a tax on federal instrumentalities. The tax was upheld (51 Sup. Ct. Rep. 170). In the course of the opinion the court says: "The precise question now presented was definitely answered in Flint v. Stone Tracy Co., 220 U. S. 107, 162 et seq., which upheld a federal tax, levied upon a corporate franchise granted by a state, but measured by the entire corporate income, including, in that case, income from tax-exempt municipal bonds. In reaching this conclusion, the court reaffirmed the distinction, repeatedly made in earlier decisions, between a tax, invalid because laid directly on governmental instrumentalities or income derived from them, and an excise which is valid because imposed on corporate franchises, even though the corporate property or income which is the measure of the tax embraces tax-exempt securities or their income. See Society for Savings v. Coite, 6 Wall. 594; Provident Institution v. Massachusetts, 6 Wall. 611; Hamilton Co. v. Massachusetts, 6 Wall. 632; Home Insurance Co. v. New York, [134 U. S. 594] supra."

After citing and commenting upon many of its own decisions in which the same or similar questions had been considered, the court continues: "Having in mind the end sought, we cannot say that the rule applied by this court for some seventy years, that a non-discriminatory tax upon corporate franchises is valid, notwithstanding the inclusion of tax-exempt property or income in the measure of it, has failed of its purpose, or has worked so badly as to require a departure from it now; or that the present tax, viewed in the light of actualities, imposes any such real or direct burden on the federal government as to call for the application of a different rule.

"The decision of this court in Macallen Co. v. Massachusetts, supra, upon which appellant relies, was not such a departure. That case did not overrule Flint v. Stone Tracy Co., supra. Instead, the opinion rested the decision on the distinguishing fact that the tax-exempt securities were included in the measure of the franchise tax by virtue

of an amendment to the taxing statute which, it was held, was specifically intended to reach the income from tax- [fol. 30] exempt national and municipal bonds which had previously not been included in the measure of the tax."

[3] In adopting the constitutional amendment, supra, providing that all banks, including national banking associations, and all financial, mercantile, manufacturing, and business corporations shall annually pay to the state a tax to be measured by or according to their net income, and that the legislature may define net income "to be the entire net income received from all sources", the people of California were but following the recommendation of their tax commissioners, supra, and the governor (advance message to the legislature, August 16, 1928), that they accept the permission granted by the congress of the United States to tax national banks "according to or measured by net income". (Sec. 5219, U. S. Rev. Stats., supra.) The rate of taxation fixed by the legislature is not higher than the rate assessed upon state banks or other corporations. The tax is not a property tax. The state Constitution authorizes the scheme of taxation, and, under the decisions of the United States Supreme Court, the federal Constitution interposes no barrier to its operation. As said by the final authority on the question: "A tax very well may be upheld against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them." (Miller v. Milwaukee, 272 U. S. 713; Macallen Co. v. Massachusetts, supra, p. 831; Educational Films Co. v. Ward, supra.)

[4] Appellant's further contention, that the profits received by it from the purchase and sale of such nontaxable securities are also constitutionally exempt from taxation by the state, is without merit. In the very recent case of Willcutts v. Bunn (United States Daily, Tuesday, January 6, 1931, 51 Sup. Ct. Rep. 125) the United States Supreme Court determined that the federal government, under the provisions of the income tax act, might properly tax the profits realized on the sale of nontaxable state securities. The opinion declares, in substance, that in the case of tax-exempt securities, the subject held to be exempt from taxation is the principal and interest of the securities, but that

it does not follow that because a tax on the interest is a tax on the securities themselves and therefore forbidden, a non-discriminatory excise tax cannot be imposed upon the profits derived from the purchase or sale of such securities. The opinion states: "The sale of the bonds by their owners, after they have been issued • • • is a transaction distinct from the contracts made by the government in the bonds themselves, and the profits on such sales are in a different category of income from that of the interest payable on the bonds." In view of this holding, we find no constitutional objection to the inclusion in the tax base of the profits received by appellant from the purchase and sale of the securities involved.

The judgment is affirmed.

Waste, C. J.

We concur: Richards, J.; Shenk, J.; Curtis, J.; Preston, J.; Seawell, J.

IN SUPREME COURT OF CALIFORNIA

DISSENTING OPINION

I dissent.

In my opinion, this cause falls squarely within the holding in the case of Macallen Co. v. Massachusetts, 279 U. S. [fol. 31] 620. The decision in the Macallen case recognizes the doctrine of the earlier case of Flint v. Stone Tracy Co., 220 U. S. 107, 163, to the effect that the taxing power may with propriety include within a franchise tax base the interest received from tax-exempt bonds, but declares that a tax upon the privilege of doing business measured in part by the amount of nontaxable interest received "may, nevertheless, be adjudged to lay a tax upon the interest, if that purpose be fairly inferable from a consideration of the history, the surrounding circumstances, or the statute itself considered in all its parts". Thus, a legislature may not by the artful use of words deprive the courts of their authority to look beyond the words to the real legislative purpose. It is for the courts to determine whether what is in form declared to be an excise tax is such a tax or, under the guise of such designation, is in substance and reality

a tax on the income derived from tax exempt property. In Miller v. Milwaukee, 272 U. S. 713, it is held: "If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail even if but for its purpose or special operation it would be perfectly good. * * * A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them, but it becomes a more serious attack upon their immunity when they are its obvious aim."

After a careful examination of the Massachusetts tax commission's report, which report undoubtedly led to the adoption of the act there attacked, and following a critical study of the act itself, the United States Supreme Court in the Macallen case, supra, declared the Massachusetts franchise tax act to be in violation of the congressional mandate exempting federal bonds and securities from taxation, and in violation of the contract clause of the Constitution, in so far as it purported to include in the tax base, interest from tax-exempt securities. While the tax in that case was designated as a "franchise tax", the court concluded from the history and circumstances surrounding its enactment that it was plainly the intention of the Massachusetts legislature to include the interest from tax-exempt securities within the tax base in order that such nontaxable securities, held in large quantities by banks and other financial corporations, might, indirectly at least, be made to bear their proportionate share of the tax burden. In other words, it was held that the act in substance and effect imposed a tax upon the exempt securities themselves in violation of the constitutional inhibition—the burden falling upon them by their use as a measure not being casual and incidental.

If, therefore, it be reasonably ascertainable that interest from tax-exempt property is included within the tax base of a franchise tax measured by net income for the purpose of reaching such nontaxable property or the income therefrom, the tax, at least in this particular, is unconstitutional and void. In so deciding the Macallen case the court did not find it necessary to overrule Flint v. Stone Tracy Company, supra, though the actual objective operation of the

tax upheld in the Flint case and that condemned in the Macallen case is identical. There can be no question, therefore, but that the court in the Macallen case held the tax void solely for the reason that it was enacted with the purpose of reaching nontaxable property.

Application of that test satisfies me that the California [fol. 32] Bank and Franchise Tax Act, supra, must fall with the Massachusetts statute in so far as it attempts to include interest from tax-exempt property in the tax base. For all practical purposes the two acts are substantially the same. Each designates the tax therein imposed as a "franchise tax", as distinguished from a property tax, but, as we have already seen, there is no magic in those words. It is our duty to look beyond the mere form of the statute and determine what, in truth and in substance, is its purpose and effect. True, as pointed out by the attorney-general, the Massachusetts attempt to include interest from tax-exempt securities within the tax base was the result of a deliberate amendment of its taxing statute to this effect whereas our statute, as originally enacted, included such interest in the tax base. To conclude that this fact alone warrants a distinction between the two cases is to hold that Massachusetts cannot take in two bites what California can have in one. Our investigation discloses that substantially the same reasons prompted the enactment of the California statute that resulted in the adoption of the Massachusetts law. The special and final reports of the California tax commission, which undoubtedly were before the legislature when it enacted the tax law corresponding to the Massachusetts tax statute, contained in substance the same observations on the possibility of reaching exempt securities as did that before the Massachusetts legislature which is quoted by the Supreme Court in the Macallen case as showing an intention to tax them by indirection. Both reports of the local taxing commission state: "As has been pointed out, the 1926 amendment to section 5219 [authorizing the taxing of national banks 'according to or measured by net income'] was drafted with the avowed object of permitting the inclusion in the tax base of such income as the interest from tax-exempt bonds. In the case of corporations other than banks, the point is not of vital importance. But the banks hold such large quantities of these tax-exempt bonds that the effect of a decision holding that the state may not

include them in the base would be very serious indeed. An analysis of the replies of the banks to the commissioner's questionnaire indicates that the noninclusion of federal bond interest would reduce that base by more than one half." With this information before it, the commission suggested to the governor and to the legislature the inclusion of tax-exempt interest in the tax base, arguing that otherwise "no substantial tax would be forthcoming from the banks". The commission appreciated the fact that the validity of the plan it was recommending had not, at that time, been judicially determined, for in its report it recognized that "a suit [the Macallen case] has already been filed in Massachusetts questioning the right of a state to include such interest". The commission's report also makes reference to the fact that New York and Massachusetts had already enacted tax statutes similar to the one proposed, thus evidencing an intention to pattern the California act after the Massachusetts statute, which has now been declared unconstitutional in the Macallen case. Then again, at the public hearing on the proposed tax measure held on January 17, 1929, before the senate and assembly sitting in committee of the whole, Professor R. M. Haig of Columbia university, who had served as technical advisor to the tax commission, while referring to the proposed tax as a "ffanchise tax" imposed for the privilege of doing business as a corporation, informed the legislature that "Interest from tax-exempt bonds is an exceedingly important item in a tax which is applied to banks." (State [fol. 33] Printing Office Publication No. 64915.) As further indicating the intent with which the California statute was proposed, and pointing out some of the difficulties confronted by the proposed act. Professor Haig, writing in the bulletin of the National Tax Association, volume XIV, page 231, 236, under date of May, 1929, states: "The proposal of the board of supervisors of San Francisco [to exclude from the tax base the interest on nontaxable securities] carried a threat of complete disaster. The exclusion of tax-exempt interest from the base was of importance only in the case of banks, who were the only large holders of government bonds. For them it meant practically complete exemption. Several of the largest and most prosperous banks in the state * * * would pay no franchise tax whatsoever. The banks themselves did not want this ex-

emption and it was they who produced evidence which on the very day of the vote on the bill convinced the San Francisco officials that its passage would not unfavorably affect the flotation of the municipal issues. Had their proposal [to exclude tax-exempt interest] prevailed the new tax would have been completely wrecked."

I am of the view that both the form and effect of the Massachusetts and California statutes are substantially identical so far as concerns the qualities that led the Supreme Court of the United States to hold the former tax void. I am also satisfied that in enacting the California Bank and Corporation Franchise Tax Act, supra, it was the legislative intention and purpose to reach nontaxable securities by including in the tax base interest received thereon. Under the holdings in Miller v. Milwaukee, supra, and the Macallen case, supra, this feature strikes at the validity of the act. It is no sufficient answer to state that the act was an emergency measure, enacted to avert a crisis which threatened the revenues of the state, or that it was intended to give to the state a modernized system of bank and corporate taxation, for in declaring the Massachusetts statute invalid as an attempt to reach nontaxable securities, the federal Supreme Court did not find that the legislature might not have other and legitimate motives as well. There can be no doubt but that the California tax commission suggested and the legislature adopted an act including interest from tax-exempt securities in the tax base, because both were convinced that banks and other corporations held such large quantities of these nontaxable securities as to require such a tax base in order to receive a "substantial tax" from such entities. The tax was aimed directly at the nontaxable securities and the interest received therefrom. In line with the decision of the Supreme Court of the United States in the Macallen case I must, therefore, conclude that in so far as the Bank and Corporation Franchise Tax Act, of this state, attempts to include interest from federal, state, municipal or other tax-exempt bonds in the tax base upon which the taxes of state banks and corporations are computed, the act in substance and effect imposes a tax upon such tax-exempt securities and is invalid and void. As to the federal bonds and securities, the act is in derogation of the constitutional power of congress to borrow money on the credit of the United States, as well

as in violation of the acts of congress declaring such bonds and securities to be nontaxable. Applying the test set up by the federal court, the same considerations that govern in the case of federal securities determine the impropriety of including the income from state, county, city and county, municipal or district bonds under the tax base measure-[fol. 34] ment plan adopted in the act. If such income is included, the act impairs the obligation of the contract created by section 1¾ of article XIII of the state Constitution, which provides that such bonds and securities "shall be free and exempt from taxation". That surely must be so as to bonds and securities issued before November 6, 1928, the date on which section 16 of article XIII of the Constitution was adopted.

The decision in the case of Educational Films Co. v. Ward, 51 Sup. Ct. Rep. 170, cited in the majority opinion, does not overrule the Macallen case but, on the contrary, is distinguishable therefrom and follows closely the earlier decisions of the United States Supreme Court. It recognizes, as does the Macallen case, that the courts must look beyond the mere form and language of a taxing statute and determine its operative effect; that is to say, the legislative characterization of a taxing statute as a "franchise" tax act is not binding on the courts if it appears that the act in substance and effect imposes an ad valorem or property tax. It also recognizes that the doctrine announced in Flint v. Stone Tracy Co. is not overruled by the holding in the Macallen case and that under the former, a state may well include within the measure of a "franchise" tax, the interest or income from tax-exempt property, but that, under the holding in the latter case [the Macallen case] this is so only when such inclusion is merely "casual and incidental" and not the result of an attempt to tax indirectly what cannot be reached directly. In other words, the decision in the Educational Films Co. case, so strongly relied on in the majority opinion, merely recognizes the two lines of cases represented by Flint v. Stone Tracy Co. and Macallen v. Massachusetts and then concludes that the New York statute involved in the Educational Films Co. case includes the income from copyrights only as an incident to the imposition of a proper franchise tax upon net income and therefore falls within the category of statutes upheld in the Flint case. In distinguishing the New York

act from the Massachusetts act declared unconstitutional in the Macallen case, the court in the Educational Films Co. case declares: "But the statute, before these amendments was sufficiently broad to include income from copyrights within the measure of the tax; and neither before nor after the amendments did it make any mention of copyrights or their income. There is nothing to suggest that the legislature could at any time have had in mind the addition of income from copyrights to the measure of the tax, or that the statute or the amendments were adopted 'for the very purpose of subjecting' it 'pro tanto to the burden of the tax', which was declared to be the vice of the statute in Macallen Co. v. Massachusetts, supra, p. 631. That the royalties play some part in the measure of the tax is the result of the application of the general language of the statute to particular circumstances to which the statute makes no specific reference. In this respect, the present statute differs in no substantial way from that upheld in Flint v. Stone Tracy Co., supra." (The statute in Flint v. Stone Tracy Co., supra, made no specific reference to tax-exempt property, such property being only incidentally included in the tax base by reason of the general language of the act referring to income from "all sources".)

From the foregoing quotation, taken from the Educational Films Co. case, it is quite clear that the New York statute there upheld made no specific reference to the in- [fol. 35] come from nontaxable copyrights but such income was included within the tax base solely by reason of the general language of the act requiring the inclusion of "income from any source". (Section 209 of the New York act.) In other words, the inclusion of income from nontaxable copyrights in the New York tax base was only "casual and incidental" to the imposition of the tax and not the result of any discoverable intent or purpose to include such income in order to reach the nontaxable subject itself.

Our statute, on the other hand, as already pointed out, makes specific reference to and requires the inclusion of tax-exempt interest from nontaxable bonds in the tax base, thus evidencing an intent and purpose, discoverable upon the face of the statute, to include such interest in the tax base as a means of requiring holders of tax-exempt securities to bear their proportionate share of the tax burden.

Then, as further pointed out, this express purpose and intent of the legislature is clearly evidenced by the report to the legislature of the California Tax Commission, which report, under the holding in the Macallen case, may properly be referred to as showing the legislative intent, and also by the quotation of statements made before the senate and assembly when sitting as a committee of the whole, and considering the enactment of the California Bank and Corporation Franchise Tax Act.

That provision of the New York statute, quoted in the majority opinion herein, which calls for the inclusion of interest from municipal and other nontaxable bonds within the tax base, though substantially the same as our act in this particular, was not before and was not considered by the United States Supreme Court in the Educational Films Co. case. That case and the decision therein were concerned solely with the inclusion in the tax base of the income from copyrights, which income was only casually and incidentally included therein by reason of the general language of the act requiring the inclusion of income from "any source". However, as already indicated, it is apparent, both upon the face of the California statute and from the legislative history thereof, that the inclusion of the interest from tax-exempt bonds was not "casual and incidental" but deliberate, the intent being to tax indirectly what could not be reached directly.

In conclusion, therefore, it may be said that the holding in the Educational Films Co. case is entirely consistent with the earlier decisions of the United States Supreme Court, but the statute there involved, so far as it concerned itself with the income from tax-exempt copyrights, the only question then before the court, properly fell within the doctrine set down in Flint v. Stone Tracy Co., whereas the California act, so far as the interest from nontaxable securities is involved, falls clearly within the category of statutes condemned in the Macallen case and is therefore unconstitutional in this respect.

Langdon, J.

[fol. 36] IN SUPREME COURT OF CALIFORNIA

Bank

Sacramento No. 4500

THE PACIFIC CO., LTD., a Corp., Plaintiff, Appellant,

vs.

CHARLES G. JOHNSON, State Treasurer of the State of California, Defendant, Respondent

On Appeal from the Superior Court in and for the County of Sacramento

JUDGMENT—Mar. 31, 1931

The above entitled cause having been heretofore fully argued, and submitted and taken under advisement, and all and singular the law and premises having been fully considered,

It is ordered, adjudged, and decreed by the Court that the Judgment of the Superior Court in and for the County of Sacramento in the above entitled cause be, and the same is hereby, affirmed, Respondent to recover costs of appeal.

Clerk's certificate to foregoing paper omitted in printing.

[fol. 37] Clerk's certificate to foregoing transcript omitted in printing.

[fol. 38] IN SUPREME COURT OF THE UNITED STATES

STATEMENT OF POINTS TO BE RELIED UPON AND DESIGNATION TO PRINT ENTIRE RECORD—Filed July 31, 1931

Comes now the appellant and adopts its assignments of error as its statement of the points to be relied upon, and represents that the whole of the record, as filed, is necessary for the consideration of the case.

Joseph D. Peeler, Counsel for Appellant.

Dated June 24, 1931.

[fols. 39 & 40] UNITED STATES OF AMERICA,
State of California,
County of ——:

Due and sufficient service of the within statement of points to be relied upon and designation of the parts of the record to be printed in the above entitled case is hereby accepted.

Charles G. Johnson, State Treasurer of the State of California, by H. H. Linney, Deputy Attorney General.

[fol. 41] [File endorsement omitted.]

Endorsed on cover: File No. 36,084. California Supreme Court. Term No. 270. The Pacific Co., Ltd., appellant, vs. Charles G. Johnson, State Treasurer of the State of California. Filed July 31, 1931. File No. 36,084.

FILE COPY

FILED
AUG 25
CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 270.

THE PACIFIC CO., LTD., A CORPORATION, *Appellant,*
vs.
CHARLES G. JOHNSON, STATE TREASURER OF THE STATE OF CALIFORNIA.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

STATEMENT AS TO JURISDICTION ON APPEAL.

JOSEPH D. PEELER,
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ROBERT N. MILLER,
MELVIN D. WILSON,
Of Counsel.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

IN THE

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OCTOBER TERM, 1931.

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THE PACIFIC CO., LTD., A CORPORATION, *Appellant*,

vs.

CHARLES G. JOHNSON, STATE TREASURER OF THE STATE OF CALIFORNIA.

STATEMENT AS TO JURISDICTION ON APPEAL.

May it Please the Court:

The appellant in support of the jurisdiction of this Court to review the above entitled cause on appeal respectfully represents:

A.

STATUTORY PROVISION SUSTAINING JURISDICTION.

The Act of February 13, 1925, Chapter 229, Section 1, 43 Stat. 936, 937 (United States Code, Title 28, Section 344), provides that Section 238 of the Judicial Code is amended to read in part as follows:

> "Section 237 (a). A final judgment or decree in any suit in the highest court of a state in which a decision in the suit could be had, where is drawn in question the validity of a treaty or statute of the United States, and the question is against its validity; or where is drawn in question the validity of a statute of any State, on the ground of its being repugnant to the Constitution, treaties, or laws of the United States, and the decision is in favor of its validity, may be reviewed by the Supreme Court upon a writ of error. The writ shall have the same effect as if the judgment or decree had been rendered or passed in a court of the United States. The Supreme Court may reverse, modify, or affirm the judgment or decree of such State court, and may, in its discretion, award execution or remand the cause to the court from which it was removed by the writ."

The Act of January 31, 1928, Chapter 14, Sections 1 and 2, 45 Stat. 54, provides as follows:

> "That the writ of error in cases, civil and criminal, is abolished. All relief which heretofore could be obtained by writ of errors shall hereafter be obtainable by appeal.
>
> "Sec. 2. That in all cases where an appeal may be taken as of right it shall be taken by serving upon the adverse party or his attorney of record, and by filing in the office of the clerk

with whom the order appealed from is entered, a written notice to the effect that the appellant appeals from the judgment or order or from a specified part thereof. No petition of appeal or allowance of an appeal shall be required: *Provided, however,* That the review of judgments of State courts of last resort shall be petitioned for and allowed in the same form as now provided by law for writs of error to such courts."

The Act of April 26, 1928, Chapter 440, Section 1, 45 Stat. 466, provides as follows:

"That section 2 of an Act entitled 'An Act in reference to writs of error,' approved January 31, 1928, Public, Numbered 10, Seventieth Congress, be, and it is hereby, amended to read as follows:

"'Sec. 2. The statutes regulating the right to a writ of error, defining the relief which may be had thereon, and prescribing the mode of exercising that right and of invoking such relief, including the provisions relating to costs, supersedeas, and mandate, shall be applicable to the appeal which the preceding section substitutes for a writ of error.'"

B.

DATE OF DECREE AND DATE OF APPLICATION FOR APPEAL.

The decree sought to be reviewed was entered on the 31st day of March, 1931. (R. 36.)*

The application for appeal was presented on the 18th day of June, 1931. (R. 2-4.)

*All references to the record are to the pages of the certified unprinted record prepared by the Clerk of the Supreme Court of the State of California and on file with the Clerk of this court. The record has not yet been printed.

C.

NATURE OF CASE AND RULING BELOW.

The case draws in question the validity of a statute of the State of California, on the ground of its being repugnant to the Constitution of the United States and the decision of the court below is in favor of its validity. (R. 24, 30.)

This case arises under a law of the State of California, entitled the Bank and Corporation Franchise Tax Act (Stat. 1929, Chap. 13, p. 19) providing for and requiring the inclusion of interest from "federal, state, municipal or other bonds" in the net income base by which the state franchise tax of banks and corporations is measured. The case relates to the inclusion by the state taxing authorities, in the appellant's net income base, of interest from certain bonds issued by improvement districts of the State of California, all of which bonds were issued and purchased by appellant prior to November 6, 1928.

Prior to November 6, 1928, these bonds, and the income therefrom, were exempt from taxation by the State of California under the provisions of Section 1-¾ of Article XIII of the State Constitution, which provides that such bonds and securities "shall be free and exempt from taxation." On the date mentioned, section 16 of Article XIII of the State Constitution was adopted, providing, in part, that corporations other than banks "shall annually pay to the state for the privilege of exercising their corporate franchises within this state a tax according to or measured by their net income." Pursuant to this constitutional amendment, the legislature passed the Bank and Corporation Franchise Tax Act which, *inter alia*,

defined the term "gross income" to include "all interest received from federal, state, municipal or other bonds." Acting under the provisions of this act, the appellee herein required the appellant herein to pay a franchise tax based in large part upon interest received by it from California district improvement bonds issued, and acquired by the appellant, prior to November 6, 1928.

After conforming with the provisions of the state law with reference to protests and refund claims, the appellant filed a suit against the appellee, the proper representative of the state in such an action, for the recovery of the taxes so paid, because they were imposed by a law which was invalid as repugnant to the Constitution of the United States, on the ground that it represented an impairment of preexisting contracts, contrary to the provisions of Article 1, section 10, of the Constitution of the United States. The trial court held that the statute was valid, and the appellant perfected an appeal to the Supreme Court of the State of California, the court of last resort in said state. In an opinion handed down on March 31st, 1931, said court affirmed the lower court, holding that the law was not repugnant to the Constitution of the United States. A dissenting opinion was filed by one member of the court, expressing the view that the law was unconstitutional as an impairment of preexisting contracts, with reference to the interest from the bonds here in question.

The majority of the Supreme Court of the State of California relied largely upon the decision of this court in *Educational Films Corporation of America v. Ward, Atty. General of New York*, 282 U. S. 379.

The dissenting member relied largely upon the decision of this court in *Macallen Co. v. Massachusetts*, 279 U. S. 620.

D.

CASES BELIEVED TO SUSTAIN JURISDICTION.

The following decisions of this court are believed to sustain jurisdiction of this appeal:

Macallen Co. v. Massachusetts, 279 U. S. 620.
Gillespie v. State of Oklahoma, 257 U. S. 501.

We respectfully submit that this court has jurisdiction of this appeal by virtue of Section 237 of the Judicial Code, as amended by the Act of February 13, 1925.

JOSEPH D. PEELER,
DONALD V. HUNTER,
Counsel for Appellant.

ROBERT N. MILLER,
MELVIN D. WILSON,
Of Counsel.

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CHARLES ELMORE C
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 270.

THE PACIFIC CO., LTD.,

Appellant,

vs.

CHARLES G. JOHNSON, State Treasurer of the State of California,

Appellee.

BRIEF FOR APPELLANT

STUART CHEVALIER,
Counsel for the Appellant.

MELVIN D. WILSON,
MILLER, CHEVALIER, PEELER & WILSON,
Of Counsel.

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in compliance with paragraph 1 of Rule 12, to which "Statement as to Jurisdiction on Appeal", reference is hereby made.

Question Presented.

Is it within the constitutional power of the State of California to impose a so-called franchise tax insofar as it is based upon income from bonds expressly exempt from tax by the State constitution at the time of their issuance, where the deliberate purpose to tax such exempt income is shown by the legislative history of the act and by the face of the statute itself?

Sections of Constitution and Statute Involved.

Section 1¾ of Article XIII of the Constitution of California, in effect when the bonds involved herein were issued, provides as follows:

> "All bonds hereafter issued by the state of California, or by any county, city and county, municipal corporation, or district (including school, reclamation, and irrigation districts) within said state, *shall be free and exempt from taxation*". (Italics ours throughout this brief.)

Following an exhaustive study of the California Tax Commission, an amendment to the Constitution was adopted on November 6, 1928. We quote the following provisions from this amendment, being Section 16, Article XIII of the California Constitution:*

> "Notwithstanding any other provision of the constitution:

*The amendment will be found set forth in full on page 77 of the "Final Report of the California Tax Commission" of March 5, 1929 filed with the briefs herein.

"1. (a) Banks, including national banking associations, located within the limits of this state, shall annually pay to the state a tax according to or measured by their net income, which shall be in lieu of all other taxes and licenses, state, county and municipal, upon such banks, or the shares thereof, except taxes upon their real property. The amount of the tax shall be equivalent to four per cent. of their net income.

• • • • •

"(c) If it be finally determined that any tax levied upon or respecting any bank, national banking association, or the shares thereof, is invalid, said bank or association, or the shares thereof, shall be reassessed in conformity with any method provided by law. No claim against the state for refund or rebate of taxes paid shall be allowed without first deducting therefrom the amount of any such unpaid reassessment.

"2. (a) All financial, mercantile, manufacturing and business corporations doing business within the limits of this state, subject to be taxed pursuant to subdivision (d) of section 14 of this article, in lieu of the tax thereby provided for, shall annually pay to the state for the privilege of exercising their corporate franchises within this state a tax according to or measured by their net income. The amount of such state tax shall be equivalent to four per cent. of their net income. Such tax shall be subject to offset, in a manner to be prescribed by law, in the amount of personal property taxes paid by such corporations to the state or political subdivisions thereof, but the offset shall not exceed ninety per cent. of such state tax. In any event, each such corporation shall pay an annual minimum tax to the state, not subject to offset, of twenty-five dollars.

• • • • •

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* * * * * *

"5. The Legislature shall define . . . 'net income' and may define it to be the entire net income received from all sources. . . ."

In pursuance of this amendment, the Legislature, in 1929, enacted the so-called "California Bank and Corporation Franchise Tax Act." (Stats. 1929, chap. 13, p. 19). It is sufficient to quote here the following provisions of that Act:

"Sec. 4. Every financial, mercantile, manufacturing and business corporation doing business within the limits of this state, of the classes referred to in subdivision 2 (a) of section 16 of article thirteen of the constitution of this state, shall annually pay to the state, for the privilege of exercising its corporate franchises within this state, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year.

"Each such corporation shall be entitled to an offset against said franchise tax, in the manner hereinafter provided, in the amount of taxes paid upon its real and personal property to any county, city and county, city, town, or other political subdivision of the state, but the total offset shall not exceed seventy-five per centum of the said franchise tax, and in no case shall the taxpayer be entitled to offset more than ten per centum of its said real property taxes.

"In any event, each such corporation shall pay annually to the state, for the said privilege, a minimum tax of twenty-five dollars. . . .

* * * * *

"Sec. 6. The term 'gross income', as herein used, includes . . . *all interest received from federal, state, municipal or other bonds.* . . .

"Sec. 7. The term 'net income', as herein used, means the gross income less the deductions allowed."

We shall review in another connection the history leading up to this general legislation, including statements by the California Tax Commission and others, showing that one of the *"major results"* sought to be accomplished thereby was to include for taxation, "if legally possible, interest from tax exempt securities".

Statement.

The appellant (plaintiff in the Court below) is a financial corporation, organized under the laws of the State of California, and engaged in business in that State. It deals largely in bonds issued by political subdivisions of the State; and during the year here involved received substantial amounts in profits from the sale thereof, and in interest paid thereon.

Appellant, on filing its franchise tax return in August, 1929, for the taxable year 1928, paid a tax of $5,018.48, based entirely upon profits realized on the sale of such district bonds (R. 6). (No question is raised on this appeal as to the validity of this tax.)

On March 17, 1930, the Franchise Tax Commissioner made an assessment of an additional tax against appellant for the taxable year 1928 of $6,692.96, plus interest from the time the tax was due (R. 9). This assessment was arrived at by adding to the tax base the sum of $167,324.11, representing interest which was received by the appellant during the taxable year 1928, on bonds issued prior to November 6, 1928, by various districts of the State of California (R. 9), which bonds were expressly exempt from

taxation at the time of issuance by Section 1¾ of Article XIII of the Constitution above quoted (R. 6, 7).

Thereafter, appellant paid under protest the tax and interest so assessed, and later brought this action to recover such payment, alleging that the tax measured by the interest received from said bonds amounted to a tax on the bonds themselves, and was in violation of Article I, Section 10, of the Constitution of the United States, being an impairment of the obligation of a contract; that the issuance of these bonds, while Section 1¾ of Article XIII of the State Constitution was in effect, constituted a contract between the various districts of the State and the buyers of the bonds, that the bonds would be exempt from all taxation by the State (R. 7).

A demurrer was filed to the amended complaint and was sustained without leave to amend (R. 12), and judgment was entered thereon in favor of the defendant, appellee herein (Rec. 14). Appellant herein then filed an appeal to the Supreme Court of the State, where the judgment of the lower court was affirmed (R. 16), Mr. Justice LANGDON dissenting (R. 26).

The statute under which this tax was assessed was enacted, as shown by its history, for the express purpose of subjecting to tax the income of property which was exempt under the constitutional provision hereinbefore mentioned.

Specifications of Error to be Urged.

The Supreme Court of California erred in holding valid the statute of that State herein involved, imposing a so-called franchise tax, in so far as such tax is expressly based upon interest received from bonds issued by a political subdivision of the State, which bonds were expressly ex-

empt from taxation by the State constitution at the time of issue.

Summary of Argument.

In this case the State of California, having by means of constitutional exemptions induced the purchase by appellant and others of certain bonds issued by its political subdivisions, deliberately set out to reach, by taxation of income, the property so exempted. The means employed was a franchise tax measured by income, with an express provision that income from such bonds was to be included. The clear effect is that holders of the bonds so purchased on the faith of such exemption are, nevertheless, taxed.

That the attempted nullification of the exemption was deliberate, is shown by the State Tax Commission's statement that a "major result" sought by the new legislation was to reach such exempt income, and by the face of the statute itself.

Thus, we are not dealing with a mere incidental or casual effect on such exempt property, but with a case in which the statute was expressly framed for the purpose of reaching such income for taxation, the State having repented of its original bargain.

To prevent such impairment of contracts by the States, Article I, Section 10 was inserted in the Federal Constitution.

The serious effect of the impairment which was suffered in this case is shown by the fact that more than one-half of the franchise tax levied against appellant arises from the inclusion in the taxing base of the interest from these exempt bonds.

The fact that the so-called franchise tax herein was to be in lieu of practically all other personal property taxes

(through the device of offsets) show that in legal and practical effect, this was a direct tax on exempt income and was so intended to be.

This case is even stronger than where a State imposes a tax on Federal securities or where the Federal Government imposes a tax on State securities. The latter situations involve only an implied constitutional prohibition growing out of the relative sovereignties of the taxing jurisdictions and where the invalidity of the tax may depend somewhat upon the degree of the burden imposed thereby; whereas here we are dealing with an absolute and express constitutional prohibition against the impairment of the obligation of contracts.

ARGUMENT.

Article I, Section 10, of the Federal Constitution, was designed to prevent any state from impairing its contractual obligations. When the State of California induced citizens to purchase the bonds of its political subdivisions by constitutionally exempting such bonds from taxation, and then, after the bonds were sold, changed its constitution and its tax system for the purpose of subjecting to tax the very property which it had held out as non-taxable, it did the very thing which the Constitutional provision was intended to stop. The short dissenting opinion rendered by Mr. Justice LANGDON in the court below (R. 26-33) reviews the history of this California legislation and the decisions of this Court on this question. Our contentions are based on the same principles as are relied on in that opinion, and recognized by this Court in *Macallen Co.* v. *Massachusetts*, 279 U. S. 620, and other cases. The facts

in the *Macallen* case were in all material respects identical with those in the case at bar. It appears to be the only decision of this Court involving squarely the question hereinabove stated, to wit, the validity of a state tax "measured by" the income from the state's own tax-exempt bonds, which the state has deliberately and expressly sought to reach and tax by that means; where from the legislative history of the Act and from the language of the Act itself, it is clear that "the avowed purpose and self-evident operation of the statute is to reach such income"; and that the legislature is deliberately "aiming" thereat.

With the utmost deference to the Court below, it is submitted that the majority decision is an erroneous one which was apparently reached through the anxiety of the Court to arrive at a conclusion which would allow the State the additional revenues which it had with such elaborate care set out to get.

1.

The Deliberate Legislative Purpose to Raise a Substantial Amount of Revenue by Specifically Taxing the Income from Exempt Bonds, is Abundantly Shown by the History of this Legislation, as Well as by the Face of the Statute Itself.

The legislative history and the provisions of the statute of California involved will now be considered insofar as they show a deliberate purpose to tax the income of the constitutionally exempt bonds.

California, prior to 1927, imposed a tax on public utili-

ties determined by a percentage of their gross earnings, on insurance companies by a percentage of their gross premiums, on the shares of banks to their shareholders based on a percentage of their capital, surplus and undivided profits, (*Bank of California* v. *Richardson*, 248 U. S. 476), and a tax on ordinary corporations on their "corporate excess". The "corporate excess" was determined by deducting from the market value of the company's capital stock and bonds outstanding, the real and personal property taxed by the subdivisions of the State (Secs. 3664 (d), 3667, 3668, Stats. and Amdts. 1917 Cal. Pol. Code); and the assessment of this "corporate excess" was held to be "an assessment of all the company's so-called intangibles". (*Miller & Lux* v. *Richardson*, 182 Cal. 115.) In arriving at this valuation, there were also deducted bonds exempt from taxation by the laws of the State and Federal Governments. (See opinion of the State Board of Equalization in *Appeal of Vortox Manufacturing Co.*, Prentice-Hall State Corp. Tax Serv. 1930, Par. 11045, and reprinted as an Appendix to this brief.)

In 1927, the legislature, doubting the validity of the state tax on national bank shares, created a Tax Commission to go fully into the matter. The Commission found that the State was in danger of losing millions of dollars of revenue through suits brought by the banks, and as a result of its study, reached the conclusion that the only practicable method of securing substantial revenue from these institutions was to proceed under the fourth method authorized by Section 5219 R. S. (44 Stats. 223; Sec. 548, Title 12, U. S. Code), and tax banks "according to or measured by their net income", and that a corresponding method of taxation be authorized by the legislature

with respect to other financial and business corporations. (Special Report of California Tax Commission, p. 11.)*

It will be recalled that Section 5219 R. S. as revised in 1926 (44 Stats. 223) permits States to tax national banks under any one of the following alternative plans, each of which includes an *ad valorem* tax on the banks' real estate:

(1) A tax on the shares.

(2) A tax on the dividends, included in the taxable income of the shareholders.

(3) A tax on the net income of the banks.

(4) A tax on the business of the banks by a tax "according to or measured by their net income."

With respect to the fourth method, the California Tax Commission said (Special Report, p. 27):

> "As distinguished from the third method, this tax is designed to include within the scope of its application certain types of income *which may not legally be reached by a pure income tax—such as interest on tax exempt government bonds.*"

On page 28, the Commission said:

> "The third method may be discarded in favor of the fourth, because under the fourth everything can be accomplished which may be gained by proceeding under the third, and presumably more besides, viz.: *the inclusion, if desired, of tax exempt interest in the base.*"

---

*"Special Report Dealing with the Taxation of Banks, Corporate Franchises, Securities and Solvent Credits, submitted August 10, 1928", State Printing Office Publication 62125, which will also be found bound in the "Final Report of the California Tax Commission, submitted to the State of California March 5, 1929", beginning on page 243 of the latter report. State Printing Office Publication 63725. For the convenience of the Court, copies of these reports are filed with the briefs herein.

The Commission, after deliberately deciding that the fourth method held the promise of the greatest revenue, because of its apparent authority to tax by indirection constitutionally exempt securities, went on to consider the application of that method to ordinary corporations. Speaking of financial corporations, such as the appellant herein, the Commission said (Special Report, p. 12):

> "While the taxation of the banks at the rate of 4 per cent. on the proposed income base will produce much less than the present yield of the tax on bank shares, nevertheless, the proposed new franchise tax on corporations *will result in greatly increased taxes for a group of financial corporations,* many of them owned by or affiliated with large banks, and the new taxes from this group will probably offset much of the expected loss in bank taxes. The new plan will not materially change the amount of the taxes for merchants and manufacturers, considered as groups."

That the revenue to be derived from the taxation of income from exempt bonds was regarded as of great importance to the State, is further clearly shown on page 40 of the Special Report of the Commission, wherein it said:

> "But the banks hold such large quantities of these tax-exempt bonds that the effect of a decision holding that the state may not include them in the base would be very serious indeed. An analysis of the replies of the banks to the Commission's questionnaire indicates that the *non-inclusion of federal bond interest would reduce the tax base of the banks approximately one-fourth and the non-inclusion of all interest exempt from the feleral income tax would reduce that base by more than one-half.*"

It seems clear that any method which would increase taxes from a group of taxpayers one hundred per cent. is

not merely casual and incidental, but extremely important. A very substantial part—more than one-half—of the total franchise taxes exacted from appellant was based on income from tax-exempt bonds. Appellant is one of the group of financial corporations whose franchise taxes the Commission, as above quoted, said would be greatly increased by the new law. (Special Report, p. 12.) Certainly it cannot be said either from the standpoint of the State or of the taxpayer that the "burden put upon the non-taxable subject by its use as a measure of value was fortuitous and incidental". (See *Macallen Co.* v. *Massachusetts*, 279 U. S., p. 628.)

The Commission was fully aware of the doubtful legality of the proposed procedure and that it had been questioned in the then pending *Macallen* case. On page 33, the Commission said:

> "Before taking up these questions, it may be pointed out that the system under analysis is not entirely novel and untried. Similar taxes have already been adopted in New York and Massachusetts."

And on page 40 of the Report the Commission said:

> "As has been pointed out (page 23), the 1926 amendment to section 5219 was drafted with the avowed object of permitting the inclusion in the tax base of such income as the interest from tax exempt bonds. The point, however, has not been adjudicated and a suit (*Macallen Company* v. *Commonwealth*) has already been filed in Massachusetts questioning the right of a state to include such interest."*

*It may be of interest to mention that subsequent to the date of this report, the Washington Supreme Court held invalid a similar statute of that State. *Aberdeen, etc. Assn.* v. *Chase* (1930), 157 Wash. 351; 289 Pac. 536. See also *Quicksafe Mfg. Co.* v. *Graham* (Tenn.), 29 S. W. (2nd) 253 (1930); *General Securities Co.* v. *Williams* (Tenn.), 29 S. W. (2nd) 662.

But before legislation along these lines could be enacted, it was necessary to amend the constitution of the State. The Commission drafted such an amendment which was adopted by popular vote on November 6, 1928. The language of the Commission, in submitting its draft of this constitutional amendment for approval, is very significant in this connection. We quote as follows from page 55 of the Special Report:

> "In preparing this draft it has been the intention of the Commission *to further the accomplishment* of the following *major results*:
>
> "(1) To eliminate the present tax on bank shares and in the future to tax banks 'according to or measured by' their net income, this net income to be defined by the legislature in accordance with the authority granted by section 5219 of the Revised Statutes, in such manner as to 'include the entire net income received from all sources', including, *if legally possible, interest from tax-exempt securities,* the banks continuing, as at present, to pay taxes on their real property.
>
> "(2) To supersede the present so-called 'franchise' or corporate excess tax authorized by subdivision (d), section 14 of Article XIII with a true franchise tax payable by all corporations doing business in the state, other than banks, such public utilities as are subject to the present gross receipts taxes, and insurance companies, the value of the franchise *to be measured by their net income, which is to be defined as in the case of banks.*
>
> "(3) To permit a credit or offset against the proposed new franchise tax on corporations for such state and local personal property taxes paid by such corporations in California as are properly attributable to the accounting period covered by the return of net income by which the new franchise tax is measured, but

to impose a minimum state tax of $25.00 even though the amount of the offset should exceed the franchise tax found to be due.

* * *

"(6) To require a reassessment of banks, or their shares, in the event that the state tax assessed against banks, or their shares, be invalid, the reassessment to be in accordance with any method made available by the congress for the taxation of national banks, or their shares, at the time of the invalid assessment."

Here was a deliberate purpose to reach the income from these tax exempt securities, "if legally possible", in the hands not only of the national banks, but of other banks and corporations doing business in the State.

Following the adoption of the constitutional amendment, the recommendations above quoted were embodied in the taxing act as finally passed. Section 6 of the Bank and Corporation Franchise Tax Act (Stats. 1929, c. 13, p. 19) contains the following definition:

"The term 'gross income' as herein used, includes . . . *all interest received from federal, state, municipal or other bonds.* . . ."

Further light on this provision will be found in the statement of Professor Robert M. Haig of Columbia University, who had served as technical adviser to the Tax Commission. In the course of a public hearing on the Senate bill embodying this Act, held on January 17, 1929,* Professor Haig, after stating that "*in the form* in which the law is drafted, it is a tax for the privilege of carrying on business in this state for a year in advance", continued (p. 9):

*Public Hearing on Senate Bills Nos. 509, 510, Relating to Revenue and Taxation, State Printing Office Publication No. 64915. Copies of this publication are filed with the briefs herein.

"Now, as to the definition of net income. You will find this material presented in section 6 and following. In the first place, the definition of income is broad, in one respect, in that it does attempt to include within the scope of the base used as the measure of the tax *income received from tax-exempt securities—that is, government bonds and so on. . . . Interest from tax-exempt bonds is an exceedingly important item* in a tax which is applied to banks. The definition is broad, in that it does include this tax-exempt interest in the base which is used as a measure of the value of the franchise."

In view of these statements, can it be fairly said that the inclusion of such income was merely fortuitous and incidental to the main purpose of the law?

Later, in explaining its opposition to a real estate offset in the new law, the Commission made it clear that the tax was essentially one directly on income as a substitute for personal property taxes, saying (Final Report, pp. 301 and 302):

"The Personal Property Tax Offset a Temporary Adjustment.—One reason why it is undesirable, in the opinion of the Commission, to grant an offset for real estate taxes is found in the fact that under the general plan for the reorganization of the tax system of the state, which the Commission proposes to recommend in its final report, the personal property offset is itself scheduled to disappear. In other words, instead of extending the offset principle, the Commission regards the privilege of offset, which has been granted to personal property, as a *temporary adjustment,* undesirable in itself, which should be eliminated at the earliest practical moment. . . . Consequently, the correct view to take of the situation is that the new franchise tax *is essentially a tax in partial substitution for the*

present taxes on personal property, the local assessment of such property being temporarily continued, because it offers a convenient solution of the problem of allocating the proceeds of this tax. In the view of the Commission, then, *the personal property offset is a temporary arrangement* which will, it is hoped, be abolished upon the adoption of the Commission's recommendations for a *comprehensive tax on the net income of corporations,* the general taxation of their real estate and the modification or *entire elimination of their tax on personal property.*"*

Compare the language of Judge CARDOZO in *People, etc.* v. *Knapp,* 230 N. Y. 48, 57, holding what was there in form a franchise tax was in practical operation a tax on income, especially as the tax was to be in lieu of all other taxes on personal property. "The reason for the apparent exemption was that, *under the form of a tax upon the franchise,* the property of such corporations had already been subjected to its share of public burdens."

In view of this frank exposition of the motives underlying the adoption of the tax on banks and other corporations, and of the real character of the tax imposed, the following language in *Macallen Co.* v. *Massachusetts,* 279 U. S. 620, 625 (holding invalid very similar legislation in that state), seems controlling:

> "As it many times has been decided, neither state courts nor legislatures, by giving the tax a particular name, or by using some form of words, can take away our duty to consider its nature and effect. . . . And this Court must determine for itself by independent inquiry whether the tax here is what, in form and

*Special Report California Tax Commission, January 15, 1929, "An Analysis of the Demand for a Real Estate Tax Offset against the Franchise Tax on Banks and Corporations", bound in the Final Report beginning on page 292, and filed with the briefs herein.

by the decision of the state court, it is declared to be, namely, an excise tax on the privilege of doing business, or, under the guise of that designation, is *in substance and reality a tax on the income derived from tax-exempt securities.*"

Again, on page 629:

"The fact that a tax ostensibly laid upon a taxable subject is to be measured by the value of a non-taxable subject at once suggests the probability that it was the latter rather than the former that the law-maker sought to reach. If inquiry discloses persuasive grounds for the conclusion *that such is the real purpose and effect of the legislation,* the tax cannot be upheld without subverting the well-established rule that ' . . . . what cannot be done directly because of constitutional restriction cannot be accomplished indirectly by legislation which accomplishes the same result.' . . .

"In the consideration of such legislation, the controlling principle, constantly to be borne in mind, is that the state cannot tax the instrumentalities or bonds of the United States, or what is the same thing, the income derived therefrom, directly or indirectly—that is to say, it cannot tax *them in any form.* Words which, literally considered, import a tax upon something else,—a tax, for example, as here, *upon the privilege of doing business measured in part by the amount of non-taxable interest received—may, nevertheless, be adjudged to lay a tax upon the interest, if that purpose be fairly inferable from a consideration of the history, the surrounding circumstances, or the statute itself considered in all its parts.* See *Home Savings Bank* v. *Des Moines,* 205 U. S. 503, 510, 521".

The Court quotes on page 632 from the Massachusetts Special Tax Commission, statements very similar to those

quoted above from the California Tax Commission. Commenting on that report, the Court said: "The effect of the report is that non-taxable bonds nevertheless should be subjected to the burden of the tax; and, since that it could not be imposed directly, the clear intimation is that it be imposed indirectly through the medium of the so-called 'excise'." (P. 633)

It may be urged here, as was done in the *Macallen* case, that there were also legitimate reasons for this legislation, that it was rendered necessary or desirable by section 5219 and that "its real object was, to avoid discrimination forbidden by federal statutes against national banks". A conclusive answer to that contention may be made in the language of this Court in that case (p. 634):

> "But it is enough to say that if such discrimination would otherwise result it must be avoided by some method which does not involve the imposition of a tax which uniformly for a century has been condemned by this Court as unconstitutional. *The state may not save itself from infringing an Act of Congress by violating the Constitution*".

The fact that the State was seeking to comply with the Federal statute furnishes no basis for disregarding the further fact that the effect of this legislation was to impair the obligation of state contracts with reference to exempt bonds. As stated by Mr. Justice LANGDON in the Court below (R. 30): "There can be no doubt but that the California tax commission suggested and the legislature adopted an act including interest from tax-exempt securities in the tax base, because both were convinced that banks and other corporations held such large quantities of these non-taxable securities as to require such a tax base in order

to receive a 'substantial tax' from such entities. The tax was aimed directly at the non-taxable securities and the interest received therefrom".

Equally pertinent is the following language of this Court by Mr. Justice HOLMES in *Miller v. Milwaukee*, 272 U. S. 713:

> "It is a familiar principle that conduct which in usual situations the law protects may become unlawful when part of a scheme to reach a prohibited result. *If the avowed purpose or self-evident operation of a statute* is to follow the bonds of the United States and to make up for its inability to reach them directly *by indirectly achieving the same result,* the statute must fail even if but for its purpose or special operation it would be perfectly good. . . . A result intelligently foreseen and offering the most obvious motive for an act that will bring it about, fairly may be taken to have been a purpose of the act. . . .
>
> "A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them, but it becomes a more serious attack upon their immunity *when they are its obvious aim.* In such a case the court must consider the public welfare rather than the artifices contrived for private convenience, and must look at the facts".

It may be observed in passing that Section 5219 R. S. attempts to give authority to the state to tax only *national* banks, according to or measured by their "net income received from all sources". Even if congress has succeeded by this act in authorizing the states to tax such banks on income from United States bonds, a question still left open (see 279 U. S. at p. 633), certainly Congress has not attempted to nor can authorize the states to tax otherwise

exempt state bonds, either to state or national banks, or to other corporations.

2.

The Constitutional Principles Applied in *Macallen Co.* v. *Massachusetts* Are Conclusive of this Case.

We have already quoted extensively above from the *Macallen* case. The facts in that case and in the case at bar will now be compared. In the history of the legislation involved, in the language of the act as passed, in its evident purpose and in its legal and practical effect, we find no point of material difference. A petition for re-hearing was overruled in the *Macallen* case, after several States, including the State of California, had filed briefs therein (280 U. S. 513). It is clear, therefore, that the question was not only very maturely considered by this Court but the possible bearing of its decision on the California law was called to its attention.

While there are, strictly speaking, certain differences between the Massachusetts and California situations, the differences are of a nature either too trivial to warrant grounding a distinction, or of such a nature that they make out a still stronger case here for the application of the rule recognized in the *Macallen* case than did the Massachusetts statute.

Thus, in California, the inclusion of interest from tax-exempt securities is permitted by an entirely new scheme of taxation, instead of inferentially through amendment of an already existing statutory plan removing the specific exemption of income from the exempt securities as in the

case of Massachusetts. But, as Mr. Justice LANGDON aptly remarked in his dissenting opinion herein:

> "To conclude that this fact alone warrants a distinction between the two cases is to hold that Massachusetts cannot take in two bites what California can have in one" (R. 28).

Again, the California statute includes interest from tax-exempt securities in a manner different from that employed by Massachusetts, but one which makes the intent to reach such income more obvious from the face of the statute than was true of the *Macallen* tax. The California act defines "gross income" as including "all interest received from federal, state, municipal or other bonds" (Cal. Stats. 1929, c. 13, secs. 6 and 7), while "net income" is gross income minus certain deductions, but no deduction is allowed for interest from such securities. The definite intent to reach such income is, therefore, apparent from a reading of the act itself in the case of California. Under the Massachusetts statute, income from Federal securities was reached by a provision defining net income "required to be returned by the corporation to the federal government under the federal revenue act . . . adding thereto . . . all interest and dividends not so required to be returned as net income". (Mass. Stats. 1925, c. 343, Sec. 1 A.) This was an amendment to an act which previously defined net income as that "required to be returned by the corporation to the Federal Government under the Federal Revenue Act . . . less . . . interest so required to be returned, which is received upon bonds . . . of the United States". (Mass. Gen. Laws, 1921, c. 63, Sec. 30 (5).)

The Massachusetts statute under which the tax was levied makes no mention of exempt securities or income

therefrom and is, therefore, less direct than the California one. It takes no reading of the California statute in relation to prior legislation to make it clear that the legislature was intent upon reaching wealth which it could not tax as property. It is also to be noted that under the rule of the *Macallen* case, the Court is not restriced to an examination of the face of the statute in order to analyze legislative motive, but may consider the history of the legislation and its surrounding circumstances. Both the reports of the State Tax Commission and the circumstances surrounding the enactment of the statute, as well as the act itself, plainly show that the aim of the California legislature was to take advantage of Congressional permission given by the 1926 amendment to section 5219 R. S. to levy taxes measured by net income, including interest from tax-exempt securities, on national banks, and to extend this to other banks and corporations, and that the legislature regarded this source of revenue as highly important.

It is clear, therefore, that insofar as there are any differences between the history, form, etc., of the Massachusetts statute and the California statute, the differences make out a stronger case against the validity of the California act.

Correspondingly also the corporation in the *Macallen* case owned a large number of bonds of Massachusetts counties and municipalities which, when issued and acquired by the corporation, were covered by the terms of a state statute (Gen. Laws, c. 59, Sec. 5, Par. 25), providing that bonds of the Commonwealth and its subdivisions "shall be exempt from taxation".

In the *Macallen* case, this Court reached the conclusion that as to the tax on Federal bonds, the act was in derogation of the constitutional power of Congress to borrow

money on the credit of the United States, as well as in violation of the act of Congress declaring such bonds to be non-taxable; and as to the county and municipal bonds, that the act impaired the obligation of the statutory contract of the State by which such bonds were made exempt from state taxation.

Bonds of Political Subdivisions of the State.

If anything, it would seem that as to the latter class of bonds mentioned by the Court in *Macallen* v. *Massachusetts,* the case is even stronger than as to Federal bonds. As to State bonds, we are dealing with a very clear, explicit constitutional prohibition against the impairment of the obligation of contracts, and not with an implied constitutional inhibition as to relative sovereignties, and not, therefore, with a mere burden on impliedly exempt subjects where the validity of the tax may, to some extent, depend upon the degree or the weight of the burden. Certainly, when we are dealing with the impairment of the obligation of a contract, the contract is either impaired or it is not. Compare *Gillespie* v. *Oklahoma,* 257 U. S. 501, making a distinction as between burdens on interstate commerce where the degree of the burden may be considered, and on federal instrumentalities, as to which latter the Court said: "In case where the principal is absolutely immune from interference an inquiry is allowed into the sources from which net income is derived and if a part of it comes from such a source the tax is *pro tanto* void. . . ." And as said in *People* v. *Bond,* 10 Cal. 563, 571, where the Court had under consideration the Federal constitutional provision against impairing the obligation of contracts: "The question is not whether by legislative alteration of a

contract a party is to be injured seriously or only slightly; *he has a right to the substance of the contract as he has made it*".

In the leading case of *Green* v. *Biddle*, 8 Wheat. 1, it was said by this Court after the second argument (p. 84):

> "The objection to a law, on the ground of its impairing the obligation of a contract, *can never depend upon the extent of the change which the law effects in it.* Any deviation from its terms, by postponing, or accelerating, the period of performance which it prescribes, imposing conditions not expressed in the contract, or dispensing with the performance of those which are, however minute, or apparently immaterial, in their effect upon the contract of the parties, impairs its obligation."

But the burden is not in fact slight in this case. It is very substantial. More than one-half of appellant's tax is based upon the income from these exempt securities (R. 6, 9); and the Report of the California Tax Commission shows that it was expected that "substantial revenue" would be raised from this very source. These considerations make it all the more important that the Court should scrutinize very carefully acts of this character in order, as stated in the *Macallen* case, "to distinguish between an exaction which, in substance and reality is what it pretends to be, and a scheme to lay a tax upon a non-taxable subject by a deceptive use of words" (p. 629).

Relying upon the provisions in Article XIII of the State constitution that such bonds "shall be free and exempt from taxation", the purchasers and holders of such bonds were warranted in feeling secure that such bonds would, in fact, be so free from taxation; and by free and exempt from taxation was meant free and exempt from all kinds of taxes,

and not merely free from all kinds except what the State might please to label a franchise tax.

The State has attempted to tax bonds which, by its constitution, it had declared to be non-taxable and which it had sold to the public under a solemn assurance that no taxes would be imposed thereon. It was to prevent just such an act by a State that the prohibition was embodied in our Federal constitution. We cannot believe that a State may be permitted thus to repudiate or impair its contracts by the device of a so-called "franchise" tax and thereby to reduce the value of its obligations in the hands of innocent holders.

To quote the vigorous language of Chief Justice TANEY in *Bronson* v. *Kinzie*, 1 How. 311, 318, in referring to this constitutional provision:

> "And it would be unjust to the memory of the distinguished men who framed it, to suppose that it was designed to protect a mere barren and abstract right, without any practical operation upon the business of life. * * * It was to maintain the integrity of contracts, and to secure their faithful execution throughout this Union, by placing them under the protection of the Constitution of the United States."

The Court quotes with approval from the opinion of Mr. Justice STORY in the earlier case of *Green* v. *Biddle*, 8 Wheat. 1, 17:

> "It is no answer that the Acts of Kentucky now in question are regulations of the remedy and not of the rights to the land. If those acts so change the nature and extent of existing remedies, as materially to impair the rights and interests of the owner, they are just as much a violation of the compact, as if they *directly overturned his rights and interests.*"

3.

Other Leading Decisions of This Court Plainly Show that Appellant is Entitled to Prevail in this Suit.

No rule in conflict with that laid down in the *Macallen* case can be derived from prior or subsequent decisions of this Court. In fact, we need look no further than the opinion of the Court in the most recent of these decisions, *Educational Films Corp.* v. *Ward,* 282 U. S. 379, to find a reconciliation of any apparent conflict and a reaffirmance of the rule of the *Macallen* case. The test as stated in *Miller* v. *Milwaukee, supra,* still is whether "the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result,—whether the tax is "aimed at" the exempt property (as quoted with approval in the *Educational Films* case, p. 393).

The *Educational Films* case involved the validity of a New York franchise tax. In the particular instance the income by which the tax was measured included royalties from copyrights granted by the United States, on which ground the appellant objected to the tax. There was nothing either on the face of the Act or in its legislative history to show that the legislature even had in mind the income from copyrights. As the Court pointed out in upholding the tax, "it cannot be said that the present tax was aimed at copyrights." After referring to certain amendments to the New York laws, the Court continued (p. 394):

> *"There is nothing to suggest that the legislature could at any time have had in mind the addition of income from copyrights to the measure of the tax,* or

that the statute or the amendment were adopted '*for the very purpose* of subjecting' it *pro tanto* to the burden of the tax', which was declared to be the vice of the statute in *Macallen Co.* v. *Massachusetts, supra,* p. 631. That the royalties play some part in the measure of the tax is the result of the application of the general language of the statute to particular circumstances *to which the statute makes no specific reference.* In this respect, the present statute differs in no substantial way from that upheld in *Flint* v. *Stone Tracy Co., supra.*" [220 U. S. 107.]

Referring to the contention that the *Macallen* case was a departure, the Court said (p. 392):

"That case did not overrule *Flint* v. *Stone Tracy Co., supra.* Instead, the opinion rested the decision on the distinguishing fact that the tax exempt securities were included in the measure of the franchise tax by virtue of an amendment to the taxing statute which, it was held, *was specifically intended to reach the income from tax-exempt national and municipal bonds* which had previously not been included in the measure of the tax. The case was thus brought within the purview of *Miller* v. *Milwaukee,* 272 U. S. 713. * * *" (The Court after quoting therefrom part of the language quoted above, p. 20, continued): "But, as the court in that case was careful to point out, in language later quoted with approval in *Macallen Co.* v. *Massachusetts,* p. 631, 'A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and *not aimed* at them'. . . . It cannot be said that the present tax was aimed at copyrights."

On the other hand, no one can seriously deny that the present tax was very definitely *aimed at* the income from exempt securities. The legislature was "gunning" for this

very income, and was frank enough so to state. Both the Constitution and the State taxing acts were amended for the admitted purpose of reaching the income from tax-exempt bonds. Before those amendments, as the State Board of Equalization pointed out in one of its opinions, Appeal of *Vortox Manufacturing Company* (Prentice-Hall California Corporation Tax Service, 1930, par. 11045, reprinted in the Appendix hereto), there was not even an attempt by the State taxing authorities to reach such exempt property, the Board saying: "There is no basis for the assertion that our Board taxed as a part of the value of general corporate franchises, property exempted from taxation under the laws of this state or of the United States."

So it may be here said, as in the *Macallen* case, that "this was a distinct change of policy on the part of the Commonwealth, adopted, as though it had been so declared in precise words, for the very purpose of subjecting these securities *pro tanto* to the burden of the tax". In fact, in the case at bar, the change was declared in precise words, if we are to give any meaning to the quotations herein made from the reports of the State Tax Commission and from the Act itself. The tax must be held to be invalid if the legislative purpose to lay the tax upon the non-taxable subject "be fairly inferable from a consideration of the history, the surrounding circumstances, or the statute itself considered in all its parts" (279 U. S., p. 629).

We have probably said enough to show that *Flint* v. *Stone Tracy*, 220 U. S. 107, is not in conflict with our contentions herein, or with the holding of this Court in the *Macallen* case. While this Court has referred to *Flint* v. *Stone Tracy* as "the extreme example" of the doctrine that taxes may be measured by income, although a part of such income is derived from non-taxable income (279

U. S., p. 628), the facts in that case put it in the class with the *Educational Films* case. In other words, in the *Stone Tracy* case there was not the slightest evidence that the legislative purpose was to lay a tax on a non-taxable subject.

In distinguishing that case and also *Home Ins. Co.* v. *New York*, 134 U. S. 594; *Society for Savings* v. *Coite*, 6 Wall. 594; and *Provident Institution* v. *Mass.*, 6 Wall. 611, this Court said in the *Macallen* case (p. 628):

> "The distinction pointed out in these cases is between an attempt to tax the property or income *as such* and to measure a legitimate tax upon the privileges involved in the use thereof. It is implicit in all that the thing taxed in form was in fact and reality the subject aimed at, and that any burden put upon the non-taxable subject by its use as a measure of value was *fortuitous and incidental.*"

Apparently, the first State law to come before this Court, relying for its validity upon the *Stone Tracy* case, was the Wisconsin statute considered in *Miller* v. *Milwaukee*, 272 U. S. 713 (1927). In that case one law taxed corporations on their income, except the income from federal bonds, while another taxed dividends received by stockholders only in so far as those dividends *or the income from which they were paid, were not taxed to the corporation.* This Court held the latter law invalid as an attempt to levy a tax on federal obligations, using the language we have quoted above, p. 20, to which we would particularly refer.

Another case to come before this Court in which a party was relying upon the *Stone Tracy* case, was *Northwestern Mutual Life Insurance Co.* v. *Wisconsin*, 275 U. S. 136, decided in November, 1927. In that case, Wisconsin imposed a license or franchise tax on life insurance companies of 3

per cent. of the gross income from all sources. This Court, in a unanimous opinion, without mentioning the history of the law, held it to be invalid as a tax on federal bonds, to the extent that interest from such bonds was included.

It is true that the Court in its opinion adverted to the fact that the tax was on gross income; but that this fact was in no wise controlling, is shown by the decision of this Court in the *Macallen* case, where the tax was on net income and in which opinion, Mr. Justice McReynolds, who wrote the opinion in the above case, concurred. See also *Gillespie* v. *Oklahoma*, 257 U. S. 501 (1922). Since the first *Pollock* case, 157 U. S. 429 (1895), it seems to be settled doctrine that income from Government bonds is as immune from a tax on net income as from a tax on gross receipts. In fact, net income from bonds is seldom likely to be much less than gross income therefrom. As a practical matter, so long as the taxpayer makes a profit from business operations, there would be a tax measured by its net income from exempt bonds which would be about as large as if measured by the total interest therefrom. The borrowing power of the United States would not be greatly relieved by an immunity confined to bonds in the hands of unsuccessful business operators.

In addition to the foregoing authorities, we might mention, without further discussion, the following cases cited by this Court in the *Macallen* case and which furnish strong analogies to the case at bar or which lay down the same governing principles:

Weston v. *Charleston*, 2 Pet. 449;
Home Savings Bank v. *Des Moines*, 205 U. S. 503;
Choctaw & Gulf R. R. v. *Harrison*, 235 U. S. 292;
Galveston, etc. Ry. Co. v. *Texas*, 210 U. S. 217;

Cook v. *Pennsylvania*, 97 U. S. 566;
Almy v. *California*, 24 How. 169;
Indian Oil Co. v. *Oklahoma*, 240 U. S. 522;
Federal Land Bank v. *Croslan*, 261 U. S. 374;
Fairbank v. *United States*, 181 U. S. 283;
Alpha Portland Cement Co. v. *Massachusetts*, 268 U. S. 203;
Frick v. *Pennsylvania*, 268 U. S. 473;
National Life Ins. Co. v. *United States*, 277 U. S. 508.

In many of these cases there were involved laws which attempted to "measure" the tax imposed by the use of a non-taxable subject and all of which were held invalid. See also *Western Union Tel. Co.* v. *Kansas*, 216 U. S. 1; *Owensboro National Bank* v. *Owensboro*, 173 U. S. 664.

Conclusion.

There are many other cases bearing more or less directly on the issue herein, but in the last analysis it would seem unnecessary to look beyond the *Macallen* case for guidance. There is no room for analogy or inference in the face of a direct authoritative decision on the exact point at issue. The distinction advanced before the Court below, that there were two acts in Massachusetts and only one in California is no distinction at all. We do not anticipate that the Court will create the illogical situation that California may do exactly what it was held Massachusetts could not do, merely because previously Massachusetts had done something else. Insofar as it is a question of legislative purpose, this purpose can be shown as clearly by one act as by a dozen.

We have discussed the various tests which have been considered in approaching this problem.

If the test is the degree or weight of the burden on the exempt securities imposed by the tax, a case could scarcely be much stronger than the present.

If the test is whether the tax "is in substance and reality a tax on the income derived from tax-exempt securities" (279 U. S., p. 626), the facts showing such to be the character of the tax seem fairly conclusive.

If the test is the motive or purpose of the legislature to reach the exempt securities and tax them, that purpose was repeatedly and unequivocally stated in the course of framing the California law.

If the test is the history and the course of the legislation itself, we have a well-nigh perfect parallel with the similar legislation of Massachusetts, held invalid by this Court; the points of difference making an even stronger case against the California law. And these several tests are really one in this case. That is to say, the fact that the legislature deliberately set out and intended to reach this exempt income is enough to carry conviction that the consequent burden thereon was likely to be and was very substantial and not merely "fortuitous and incidental".

Finally, if broad considerations of policy are to have controlling weight, we would urge that the need to examine taxing acts to see that the use of tax-exempt subjects as a measure for taxes imposed in terms upon taxable subjects is not in reality a cloak, under which the former in substance and effect are taxed, was never more imperative than now when by reason of increased and increasing public expenditures, states and municipalities are driven to search in every direction for additional sources of revenue.

If this legislation is upheld, no great ingenuity will be required to frame laws that will subject to heavy and de-

structive taxes, securities, state and federal, which have been issued under constitutional guaranties of tax exemption.

In substance, though not in form, in effect, though not in name, this tax is a direct tax on exempt income; whether we regard this as a franchise tax or a thinly disguised tax on the income itself, the legal and the practical result is the same, a serious burden deliberately laid on a subject constitutionally exempt from tax. Both in form and substance it is a tax on the source of the income *qua* the exempt source; and such a tax this court has never upheld.

We respectfully request, therefore, a reversal of the decision of the lower Court.

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MILLER, CHEVALIER, PEELER & WILSON,
Of Counsel.

APPENDIX.

IN MATTER OF APPEAL OF VORTOX MANUFACTURING COMPANY

(STATE BOARD OF EQUALIZATION, AUG. 4, 1930)

APPEARANCES:

For appellant, MESSRS. NICHOLS, COOPER AND HICKSON.

For Respondent, HON. REYNOLD E. BLIGHT, *Franchise Tax Commissioner.*

OPINION.

This is an appeal under Section 25 of the Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929) from the action of the Franchise Tax Commissioner in overruling the protest of Vortox Manufacturing Company against a proposed assessment of an additional tax of $4,110.54, with interest.

The sole point involved in this appeal is whether amounts received as royalties for the use of patent rights issued by the United States Government are subject to inclusion in the tax base under this statute. The Commissioner has proceeded in reliance upon language of the Act which apparently authorizes him to include such income, while the taxpayer protests that this procedure is violative of the Constitution of the United States. The question is of paramount importance and presents itself in many similar appeals. Consequently, we have deferred our decision until now so that we might be afforded opportunity for mature deliberation on the problem.

Section 4 of the Act specifies that certain classes of corporations, in which appellant is apparently included,

must pay annually to the State a tax "according to or measured by" their net income, less certain offsets for property taxes paid locally. "Net income" is defined in Section 7 of the Act as the "gross income", less allowable deductions. "Gross income" is defined in Section 6 of the Act as follows:

> "The term 'gross income', as herein used, includes gains, profits and income derived from the business, of whatever kind and in whatever form paid; gains, profits or income from dealings in real or personal property; gains, profits or income received as compensation for services, as interest, rents, commissions, brokerage or other fees, or otherwise received in carrying on such business; all interest received from federal, state, municipal or other bonds, and, except as hereinafter otherwise provided, all dividends received on stocks."

There is no provision in the Act for the deduction of income from tax-exempt sources. For this reason, the Commissioner has insisted upon the inclusion of the royalties from patent rights, although it is obvious that the patents themselves are not taxable. (*Long* v. *Rockwood,* 277 U. S. 142.) The appeal is based upon the proposition that inclusion of patent royalties in the tax base is, in effect, taxation of income from a federal instrumentality.

In support of this view the appellant cites two recent decisions of the United States Supreme Court. One of these, *Long* v. *Rockwood,* 277 U. S. 142, holds that a state may not tax directly royalties from patents. The other, *Macallen* v. *Massachusetts,* 279 U. S. 620, holds that, under the guise of an excise tax measured by net income, a state may not tax income from exempt sources, such as federal and state bonds, thereby accomplishing by indirection what it is forbidden to do directly.

Each of these cases involves taxing statutes of the Commonwealth of Massachusetts, and the Franchise Tax Com-

missioner seeks to differentiate the "history" of the effort to reach tax-exempt income by "excise" taxation there and in California. We do not find the "differences" urged particularly convincing. It is true that the taxation of income from exempt sources was sought to be accomplished in Massachusetts through amendment of an existing excise statute rather than through adoption of an entirely new law as in California. But to make this a vital point of difference would be virtually to hold that Massachusetts may not take in two bites what California may have in one.

Analyzing the former tax on general corporate franchises assessed under Section 3664d of the Political Code, the Franchise Tax Commissioner has attempted to show that under it the tax-exempt property of corporations was actually included in the value of the corporate franchises as ascertained by our Board. This reveals a lack of understanding of what constitutes the value of a corporate franchise, because the constitutional and statutory provisions under which we proceeded certainly did not contemplate that the franchise value of corporations would be increased through their ownership of exempt property. In arriving at the worth of a corporate franchise we were required to ascertain the total worth of the corporation through the known value of its stocks and bonds, capitalization of its net earnings or some other accepted method. From this total corporate worth we deducted the intrinsic value of its assets, including tax-exempt property, in order that we might arrive at the corporate "excess", which had been established as the proper basis for franchise assessment. (*Miller & Lux* v. *Richardson*, 182 Cal. 115.) Certainly, this "corporate excess" or franchise value could not be said to include the value of tax-exempt property.

Our forms for report, prepared under the provisions of Section 3667 of the Political Code, called explicitly for "the market or actual value of non-assessable real and per-

sonal property owned by the company" on the assessment date. They also called for the income received from this type of property. These factors were required for the express object of assuring that we should be in a position to make due allowance for the ownership of such property and the income derived therefrom when valuing corporate franchises. There is no basis for the assertion that our Board taxed as a part of the value of general corporate franchises property exempted from taxation under the laws of this state or of the United States.

So far as the policy of the state with reference to taxation of banks is concerned, any inference to the effect that exempt property was taxed under subdivision (*c*) of Section 14 of Article XIII of the Constitution or Section 3664c of the Political Code is drawn in apparent disregard of the fact that these provisions called for a tax on bank shares and not on banks themselves. It is a fundamental conception of the law that a tax on the stock of a corporation is not rendered unconstitutional because the corporation owns securities which are exempt from taxation, while a tax on those same securities, or on the income therefrom, would be invalid. (*Bank of California* v. *Roberts,* 248 U. S. 492.) It has been held that a tax upon bank stock is not a tax on exempt securities, even though the value of the stock may be influenced through the ownership of such securities by the bank. (*Des Moines National Bank* v. *Fairweather,* 263 U. S. 103.) Therefore, we find nothing in the "history" of California taxation which justifies the conclusion that we have taxed in the past, either corporations generally or banks particularly, on account of their ownership of tax-exempt property.

Concerning the auspices under which the present tax on banks and corporations "according to or measured by" their net income was introduced, only brief comment need be made. In its report recommending the plan to the Legislature the Special Tax Commission created under Chapter

455, Statutes of 1927, discussed its reasons for proposing the adoption of the measure. It said that the share tax method then employed with reference to banks was probably invalid, citing the case of *Merchants National Bank of Richmond* v. *Richmond,* 256 U. S. 635. It discussed the four alternatives allowable under Section 5219, U. S. Revised Statutes, relating to state taxation of national banks, and concluded that "the only practicable method of securing a substantial revenue from the banks is to proceed under the fourth method permitted by the federal statutes, and tax banks 'according to or measured by net income.'" (Final Report of the California Tax Commission [March 5, 1929], p. 247.)

Discussing the origin of this method, the Commission said:

> "The original proposal for this amendment was prepared and submitted to the congress as a result of the joint activities of a committee of the American Bankers Association and a committee of the National Tax Association. The known purpose of these committees was to modify the 1923 amendment so as to permit a law such as the franchise tax on income of corporations in force in New York state to be applied to national banks. This intention is also plainly stated in the report of the House Committee on Banking and Currency." (Final Report of the California Tax Commission [March 5, 1929], p. 259.)

Rejecting as undesirable the taxation of banks and corporations directly on their net income under the third alternative provided by Section 5219 of the U. S. Revised Statutes, the Commission assigned its reasons as follows:

> "The third method may be discarded in favor of the fourth, because under the fourth everything can be accomplished which may be gained by proceeding under the third, and presumably more besides, viz., the inclusion, if desired, of tax-exempt interest in the base."

Appendix.

(Final Report of the California Tax Commission [March 5, 1929], p. 264.)

Continuing its discussion of the problems involved, the Commission said:

> "As has been pointed out, the 1926 amendment to Section 5219 was drafted with the avowed object of permitting the inclusion in the tax base of such income as the interest from tax-exempt bonds. The point, however, has not been adjudicated and a suit (The *Macallen Company* v. *Commonwealth of Massachusetts*) has already been filed in Massachusetts questioning the right of a state to include such interest.
>
> "In the case of corporations other than banks, the point is not of vital importance. But the banks hold such large quantities of these tax-exempt bonds that the effect of a decision holding that the state may not include them in the base would be very serious indeed. An analysis of the replies of the banks to the Commission's questionnaire indicates that the non-inclusion of federal bond interest would reduce the tax base of the banks approximately one-fourth and the non-inclusion of all interest exempt from the federal income tax would reduce that base by more than one-half." (Final Report of the California Tax Commission [March 5, 1929], p. 276).

Later, in explaining its opposition to a real estate offset in the new law, the Commission made it clear that the tax was essentially one on income as a substitute for personal property taxes, saying:

> "The Commission regards the privilege of offset, which has been granted to personal property as a temporary adjustment, undesirable in itself, which should be eliminated at the earliest practical moment. * * * The correct view to take of the situation is that the new franchise tax is essentially a tax in partial substitution

for the present taxes on personal property, the local assessment of such property being temporarily continued, because it offers a convenient solution of the problem of allocating the proceeds of this tax." (Final Report of the California Tax Commission [March 5, 1929], pp. 301, 302.)

This frank exposition of the motives underlying the adoption of the tax on banks and corporations "according to or measured by" their net income is closely reminiscent of the language employed by the Massachusetts Tax Commission and commented upon by the United States Supreme Court in its decision of the *Macallen* case (*supra*). Consequently, this part of the "history" of the California Act, to our discernment, does not differ vitally from what transpired in Massachusetts.

However, it is plain that our law contemplates the inclusion of income from exempt sources in the tax base. If we should rule that the Commissioner erred in making the additional assessment to accomplish such inclusion, we should have to do so upon the assumption that the Act is unconstitutional.

The power to declare a law unconstitutional is one of the highest attributes of judicial authority. Although we sit in these matters as a quasi-judicial body, and must decide questions of law as well as of fact, we should not lose sight of the ultimate fact that we are not a Court but merely an administrative Board. The right of a ministerial office to question the constitutionality of a statute is generally denied. (6 R. C. L. 92.)

It is true that we have occasionally asserted that right. But this has been only under circumstances wherein such action on our part was necessary in order to protect the revenues of the state and get the problem before the Courts. (*Miller & Lux* v. *Richardson*, 182 Cal. 115.) In the instant case, and in all others like it before us, the taxpayers will

have the opportunity of taking the question to the Courts for decision. (Stats. 1929, Chapter 13, Sec. 30.)

It might be argued that, if the law is plainly unconstitutional, why should taxpayers be put to that trouble and expense? However, there is diversity of opinion as to the constitutionality of the Act, and it seems to us desirable that this controversy should be settled by the Courts, whose authority to hold acts of the Legislaure invalid cannot be questioned.

Much reliance is placed by the Commissioner on the decision of the United States District Court for the Southern District of New York on June 6, 1930, in the case of *Educational Films Corporation of America* v. *Ward,* Fed. (2d) (reported in United States Daily in the issue of Friday, June 6, 1930, at p. 9), declaring that a taxing statute of New York similar to ours does not violate the Federal Constitution though it includes income derived from federal copyrights in the tax base. This ruling is being vigorously contested and will be carried to the higher courts.

On the other hand, the Supreme Court of Washington, in an opinion handed down June 12, 1930, in the case of *Aberdeen Savings & Loan Assn.* v. *Chase,* . Pac. (reported in United States Daily in the issue of June 20, 1930, at page 9, *et seq.* and June 21, 1930, at page 9), held that an income tax measure of that state patterned after the California statute, save as to the classes of corporations included, is invalid as an attempt to tax income from exempt sources.

Expressing much the same view, the Supreme Court of Tennessee in a decision rendered on June 28, 1930, in the case of *Quicksafe Manufacturing Corporation* v. *Graham,* S. W. (reported in United States Daily in the issue of July 23, 1930, at page 8), held that a corporate excise tax, measured by net income, may not be based upon royalties from patents.

These decisions are indicative of the diversity of opinion to which we have already alluded. In view of all the surrounding circumstances, we do not feel warranted in deciding that, under the California Bank and Corporation Franchise Tax Act, income from exempt sources may not be included in the tax base.

ORDER.

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, that the action of Reynold E. Blight, Franchise Tax Commissioner, in overruling the protest of Vortox Manufacturing Company, a corporation, against a proposed assessment of an additional tax of $4,110.54, with interest, under Chapter 13, Statutes of 1929, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of August, 1930, by the State Board of Equalization.

R. E. Collins, Chairman; H. G. Cattell, Member; Jno. C. Corbett, Member; Fred E. Stewart, Member.

(From Prentice-Hall State Corporation Tax Service, Par. 11,045.)

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CHARLES ELMORE

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1931

No. 270

THE PACIFIC CO., LTD.,
Appellant,

vs.

CHARLES G. JOHNSON, State Treasurer of the State of California,
Appellee.

BRIEF FOR APPELLEE

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IN THE

SUPREME COURT

OF THE

UNITED STATES

OCTOBER TERM, 1931

No. 270

THE PACIFIC CO., LTD.,
Appellant,

vs.

CHARLES G. JOHNSON, State Treasurer of the State of California,
Appellee.

BRIEF FOR APPELLEE

FOREWORD

This appeal involves the constitutionality of that portion of the Bank and Corporation Franchise Tax Act of California (Statutes of California for 1929, page 19), measuring the amount of the State corporation franchise tax by percentage of net income and including within the income by which the amount of the tax is measured interest received from "Federal, State and municipal or other bonds."

Predicating its cause of action upon the alleged unconstitutionality of that portion of said act, appel-

lant brought this tax recovery proceeding. Appellee's demurrer to the complaint was sustained without leave to amend and judgment was thereupon entered against appellant. An appeal was then taken to the Supreme Court of California, which affirmed the judgment of the trial court.

The Pacific Co., Ltd., vs. *Johnson*, 81 C. D. 519, 298 Pac. 489.

Upon application to this court a writ of *certiorari* was allowed.

STATEMENT OF THE CASE

Appellant is now and during all of the times hereinafter mentioned was a California corporation engaged in the buying and selling of securities, including bonds of California improvement districts. As such it is subject to the payment of a corporation franchise tax in accordance with the provisions of section 16 of Article XIII of the Constitution of California and the Bank and Corporation Franchise Tax Act.

During the calendar year 1928 appellant received from California improvement district bonds issued prior to November 6, 1928, profits in the sum of $651,732.75 and interest in the sum of $167,324.11. Also, in that year appellant received interest of $2,624.07, on improvement district bonds issued after November 6, 1928.

That interest and those profits were set forth by appellant in making, in 1929, its return of its net

income for the calendar year 1928. In 1929 appellant involuntarily paid to the State its franchise tax based on the said net income, which included that interest and those profits. Appellant's claim for refund, based on the contention that the interest and profits were improperly included in the process of calculating appellant's State franchise tax, was rejected by the Franchise Tax Commissioner, whereupon this recovery action was filed under the authority of section 30 of the act.

In the State courts appellant complained of the inclusion of said profits, as well as said interest, in the tax base, but its objection with reference to the profits has been abandoned by appellant and is not before this court, probably on account of the decision of this court in

Willcutts vs. *Bunn,* 51 Sup. Ct. Rep. 125, 282 U. S. 216.

APPELLANT'S CONTENTION

Appellant's single contention is centered upon section 1¾ of Article XIII of the Constitution of California, which reads as follows:

> "All bonds hereafter issued by the State of California, or by any county, city and county, municipal corporation, or district (including school, reclamation, and irrigation districts) within said State, shall be free and exempt from taxation."

Appellant argues that the provision quoted established a contract between appellant and the State

of California granting complete tax immunity to the holders of the bonds in question and that the terms of the said Bank and Corporation Franchise Tax Act and their application by the State to appellant in the exercise of its corporate privileges, are such as to offend against section 10 of Article I of the Constitution of the United States.

APPELLEE'S CONTENTIONS

Appellee replies:

First: That the tax imposed under said Bank and Corporation Franchise Tax Act is an excise for the privilege of exercising corporate rights and privileges in California and is not a property tax.

Second: That section 1¾ of Article XIII of the California Constitution is an exemption from property taxes only; it does not express an obligation to exempt the bonds in question from taxation under the State Bank and Corporation Franchise Tax Act, and, consequently, there is no impairment of any obligation of any contract, and, therefore, no violation of section 10 of Article I of the Constitution of the United States.

Third: Assuming, without conceding, that the language of section 1¾ of Article XIII of the Constitution of California, adopted in 1902, comprehended an exemption from that kind of a tax provided for in said Bank and Corporation Franchise Tax Act, that exemption was withdrawn and eliminated by subsequent changes in the California Constitution.

A BRIEF HISTORY OF EVENTS PRECEDING THE ENACTMENT OF THE BANK AND CORPORATION FRANCHISE TAX ACT

This is the first case to bring the Bank and Corporation Franchise Tax Act before this court, and a brief reference at this point to matters preceding its adoption would seem to be in order.

The California Constitution was amended in 1910 to effect a separation of sources and to introduce variations from the *ad valorem* tax in the matter of State and local taxation. By that amendment section 14 was added to Article XIII, and a change was made in section 1 of that article to conform to the exceptions which section 14 created to the original, uniform, *ad valorem* tax system.

Confining our review to those features of the 1910 amendment pertinent to a consideration of this cause, that amendment directed the taxation by the State of the shares of stock of National and State banks at a stated percentage, subject to legislative change by a two-thirds vote of each house, of the value of the shares. The value of a share was the amount paid in thereon together with its pro rata of the accumulated surplus and undivided profits. The tax upon the share was in lieu of all taxes and licenses, State and local, upon such shares and upon the property of such banks, except local taxes on real estate.

Section 14 of Article XIII, subdivision (d), also directed the assessment of all "franchises" at their

actual cash value, in a manner to be provided by law, and the levy thereon of a State tax at a fixed rate which was also subject to legislative change by a two-thirds vote of each house.

The State tax on bank shares of stock was before the Supreme Court of California in

Bank of California vs. *Roberts*, 173 Cal. 398,

and before this court in

Bank of California vs. *Roberts*, 248 U. S. 476.

The State "franchise" tax provided for by said subdivision (d) of section 14 of Article XIII was analyzed and held to be in reality a "corporate excess" tax, not an excise, by the Supreme Court of California in

Miller and Lux vs. *Richardson*, 182 Cal. 115.

Permission to tax shares of stock in National banks upon their value exists in section 5219 of the Revised Statutes of the United States but Congress has annexed the condition that moneyed capital employed in competition with National banks must be subjected by the states to a like tax burden. Prior to 1927 the states were in doubt as to the extent to which that qualification applied, but any uncertainty was definitely dispelled in March of that year by the decisions of this court in the cases of

First National Bank vs. *City of Hartford*, 273 U. S. 548; 47 S. Ct. 462;

Georgetown National Bank vs. *McFarland*, 273 U. S. 568; 47 S. Ct. 467;

State of Minnesota vs. *First National Bank of St. Paul*, 273 U. S. 561; 47 S. Ct. 468.

In those decisions it was held that section 5219 is not directed merely at discriminatory taxation which favors a competing banking business; that competition, in the sense intended, arises not from the character of the business of those who compete, but from the manner of the employment of the capital at their command; and that the section was intended to prevent the fostering of unequal competition with the business of National banks by the aid of discriminatory taxation in favor of capital invested by institutions or individuals engaged either in similar business or in particular operations or investments like those of National banks.

Basing their attack upon the principles thus laid down by this court, scores of actions were filed in the year 1927 against the State of California by National and State banks alleging that our tax system illegally discriminated in favor of competing moneyed capital. Apparently the actions were well founded and the State was faced with the probability that it would be forced to return to the banks practically five million dollars in taxes for the years 1926 and 1927 and that the potential loss to the State would approximate twenty-two million dollars unless a change was immediately made in the tax system.

About the time those actions were filed it happened that there was in the process of organization a State

Tax Commission appointed by the Governor of California under the direction of an act of the Legislature to make a general study of the California tax situation. The emergency created by the pendency of those actions demanded the immediate attention of that body. All of the energies of that commission were rallied to meet the emergency.

After months of intensive investigation, under the guidance of an internationally recognized technical adviser, the commission recommended to the Governor that the Legislature be convened in extraordinary session to propose a constitutional amendment. A special session was called and the Legislature unanimously proposed that the State tax system be amended through the addition of section 16 to Article XIII of the Constitution. At the general election in November, 1928, the amendment was adopted.

Section 16 of Article XIII abandoned the tax on bank shares and substituted a State tax on National and State banks in an amount measured by a percentage of their net income. Permission to do so had been extended by Congress in its 1926 amendment of section 5219 R. S. The amendment provides that if banks are so taxed the net income may "include the entire net income received from all sources." *It adds the condition,* however, that the burden so imposed upon National banks shall not exceed the burden imposed by the taxing state upon other financial corporations or upon mercantile,

manufacturing and business corporations doing business within its limits.

To insure certain and complete compliance with the conditions annexed to the permission so granted by Congress, said section 16 of Article XIII substituted for the "corporate excess" tax on general corporations, a State franchise tax on all financial, mercantile, manufacturing and business corporations doing business in California, other than utilities taxed by the gross receipts method, measured in amount at 4 per cent of their net income from business done in California.

Section 16 of Article XIII of the California Constitution reads, in full, as follows:

"Notwithstanding any other provision of the constitution:

1. (a) Banks, including national banking associations, located within the limits of this state, shall annually pay to the state a tax according to or measured by their net income, which shall be, in lieu of all other taxes and licenses, state, county and municipal, upon such banks, or the shares thereof, except taxes upon their real property. The amount of the tax shall be equivalent to four per cent of their net income.

(b) The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, in lieu of such tax, may provide by law for any other form of taxation now or hereafter permitted by the congress of the United States respecting national banking associations; provided, that such form of taxation shall apply

to all banks located within the limits of this state.

(c) If it be finally determined that any tax levied upon or respecting any bank, national banking association, or the shares thereof, is invalid, said bank or association, or the shares thereof, shall be reassessed in conformity with any method provided by law. No claim against the state for refund or rebate of taxes paid shall be allowed without first deducting therefrom the amount of any such unpaid reassessment.

2. (a) All financial, mercantile, manufacturing and business corporations doing business within the limits of this state, subject to be taxed pursuant to subdivision (d) of section 14 of this article, in lieu of the tax thereby provided for, shall annually pay to the state for the privilege of exercising their corporate franchises within this state a tax according to or measured by their net income. The amount of such state tax shall be equivalent to four per cent of their net income. Such tax shall be subject to offset, in a manner to be prescribed by law, in the amount of personal property taxes paid by such corporations to the state or political subdivisions thereof, but the offset shall not exceed ninety per cent of such state tax. In any event, each such corporation shall pay an annual minimum tax to the state, not subject to offset, of twenty-five dollars.

(b) The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, may provide by law for the taxation by any other method authorized in this constitution of the corporations, or the franchises, subject to be taxed pursuant to subdivision (a)

of paragraph 2 of this section or subdivision (d) of section 14 of this article.

3. The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, may change by law the rates of tax, or the percentage, amount or nature of offset provided for in paragraphs 1 and 2 hereof.

4. Notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, mortgages, and any legal or equitable interest therein, of the classes now taxable to the owner thereof and not otherwise taxed under subdivisions (a) or (b) of section 14 or under section 15 of this article, shall be declared in a manner to be prescribed by law and shall be taxed upon their actual value at the rate of three-tenths of one per cent. The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, may by law change the rate or rates upon any one or more of the classes of property herein enumerated, provided that no rate shall exceed four-tenths of one per cent. Said tax shall be in lieu of all other property taxes thereon, and the proceeds of said tax shall not go to the state but to such political subdivisions thereof, and in such manner, as may be provided by law.

5. The Legislature shall define "corporations" and "doing business"; shall define "net income" and may define it to be the entire net income received from all sources; shall provide for the allocation of income, for the assessment, levy and collection of the aforesaid taxes, and for reassessment in the event of the invalidity of any tax under 2 (a) or 2 (b) hereof. Said taxes shall be-

come a lien on the first Monday in March of 1929 and of each year thereafter. The Legislature shall pass laws necessary to carry out this section. The acts of the forty-eighth session of the Legislature passed pursuant to this section shall be effective immediately upon their passage."

By the terms of section 16 of Article XIII the tax upon the corporations other than banks, therein specified, is declared to be an annual tax for the privilege of exercising their corporate franchises within this State. In paragraph 5 of the section the Legislature is directed to define "net income," and is authorized to define it "to be the entire net income received from all sources." The same paragraph instructed the Legislature to enact enabling legislation, which brought into existence the Bank and Corporation Franchise Tax Act, effective March 1, 1929.

The Bank and Corporation Franchise Tax Act defined "net income" (section 7) to be the "gross income" less certain deductions. "Gross income" is defined in section 6 to include "all interest received from Federal, State, municipal or other bonds." The deductions from gross income are prescribed in section 8. The rate of the tax is fixed by section 16 of Article XIII at 4 per cent. Acting under the authority delegated to it by said section, the Legislature went beyond the offset provision fixed in the constitutional section and has provided that a corporation shall be entitled to an offset

against the State franchise tax in the amount of taxes paid locally upon its real and personal property with the qualification that the total offset shall not exceed 75 per cent of the State tax, and that in no case shall the corporation be entitled to offset more than 10 per cent of its real property taxes. By the statute the banks are given the benefit of the same offset provision except that the personal property of National and State banks is exempt from personal property taxation under the terms of section 16 of Article XIII.

The Bank and Corporation Franchise Tax Act recognizes that some corporations keep their books and accounts on a fiscal year basis and others on a calendar year basis, and therefore the "taxable year" is defined in section 11 to mean either the calendar or fiscal year, as the case may be. The tax is prospective in its operation under the terms of the act, and is administered by the Franchise Tax Commissioner for whom provision is made in section 22. Applying the statute to the case of this appellant corporation, which keeps its books on the calendar year basis, it was obliged, by reason of section 13 of the act, to report to the commissioner its "net income" during the calendar year 1928. The State tax measured by that net income, less such offsets as appellant was entitled to, represented a tax to the State by appellant for the privilege of exercising its corporate franchises within the State during the calendar year 1929.

APPELLEE'S ARGUMENT

I

The Tax in Question Is a Valid Excise

It is apparent that the fundamental issue in this case is the nature of the tax herein involved, with particular reference to whether that tax is a tax on the bonds or is a true franchise, or excise, tax.

(a) A Technical Analysis of the Tax.

In section 16, Article XIII of the California Constitution, the tax imposed upon appellant is denominated a tax for appellant's privilege of exercising its corporate franchises within this State. In making this observation we are not arguing that this characterization of the tax is of controlling importance in determining whether the tax is consistent with the Federal Constitution, but we are arguing that the circumstance has a real significance in testing the tax against other sections of the California Constitution. That designation of the tax by section 16 of Article XIII is repeated by the Legislature in section 4 of the Bank and Corporation Franchise Tax Act.

The statutory definition of "net income" is the yardstick by which appellant's State franchise tax for 1929 has been measured. A restatement, with further detail, of the processes by which the net income is calculated will demonstrate that income from bonds immune to property taxes is but incidentally related to the amount of the State franchise tax.

The taxpayer is required by the statute to report its entire gross income, including the interest received from bonds of all kinds. The taxpayer is entitled to deduct from its gross income all of the allowances prescribed in section 8 of the act which, generally stated, cover operating expense, certain taxes and licenses including Federal income tax, losses, debts, depletion, depreciation, and dividends received from income arising out of business done in California. If the difference between the gross income and the deductions represents net income from business not entirely done in California, if that difference represents income from business having its source in corporate activity by the taxpayer outside of California, then, according to section 10, there must be an apportionment or allocation of the entire net income in order that it may be determined what proportion of the entire net income represent business done or having its source in the taxpayer's corporate activity in California. Section 10 declares that the object of such apportionment is to assign to California that portion of the entire net income reasonably attributable to business done in California and to avoid subjecting the taxpayer to double taxation.

When the net income from business done in California is thus determined the amount thereof becomes the basis by which the amount of the franchise tax is measured. The 4 per cent rate is applied to the net income and against the amount thus produced

the taxpayer is entitled to the offsets above described. The remainder is the tax for which it is liable.

It is apparent, therefore, that the franchise tax is not levied by necessary intendment upon every dollar of interest and profits that a taxpayer receives from bonds exempt from property taxes. It is conceivable that conditions might exist whereby the amount of the franchise tax would not be increased by the receipt of income from such bonds. The amount of the tax, manifestly, does not vary in exact proportion to the gross income from the bonds included in the aggregate.

(b) A Corporation Franchise Tax Measured by a Percentage of Net Income is Not a Property Tax.

This court has consistently held, over a long period of years, that either the State or the Nation may legally impose a franchise tax upon corporations for the right to exercise their corporate privileges, measured in amount by a percentage of net income although a portion of the income is derived from property which in itself is nontaxable, the court stating that the distinction lies between the attempt to tax the property as such and to measure a legitimate tax upon the privileges involved in the use of such property.

Flint vs. *Stone-Tracy Co.*, 220 U. S. 107;
Maine vs. *Grand Trunk R. R. Co.*, 142 U. S. 217;
Galveston R. R. Co. vs. *Texas*, 210 U. S. 217, 226;
Bass, etc., Co. vs. *State Tax Commission*, 266 U. S. 271;

New York vs. *Jersawit*, 263 U. S. 493, 496;
Educational Films Corp. vs. *Ward*, 282 U. S. 379.

The *Flint* case involved the Federal Corporation Tax Act of 1909 which imposed a tax with respect to the carrying on or doing business by corporations, the tax to be assessed upon net income received from all sources. The report of the *Flint* case discloses that a most vigorous attack was launched against the Federal statute because of the reflection of income from nontaxable bonds in the amount of the tax; that the attack was conducted by many eminent lawyers, with an equally imposing array of counsel in defense of the statute; that there was a most thorough and exhaustive consideration of the basic point upon which this appeal is founded; and that there was an exploration into the depths of all of the decisions bearing upon the matter and handed down prior to the *Flint* decision.

The *Bass* and *Jersawit* cases involved the Corporation Franchise Tax Act of New York upon which the California act is closely patterned. They did not involve the question of including interest from nontaxables in the net income base, although the New York law provides for such inclusion, but in each case it was definitely held that the tax was *not* a tax upon income but "primarily a tax levied for the privilege of doing business in the state."

Flint vs. *Stone-Tracy Co.* is generally regarded as the leading case not only to the effect that a tax

for the privilege of exercising corporate privileges measured by a percentage of net income is not a property tax but also as authority to the effect that the inclusion of interest from nontaxables in the net income yardstick is legitimate. This decision in both aspects noted has been approved and applied as sound precedent in the following cases, which include the *Macallen* case upon which appellant places its entire reliance:

McCoach vs. *Mineville Ry. Co.*, 228 U. S. 295, 387;
Stratton's Independence Ltd. vs. *Howbert*, 231 U. S. 399, 416;
Interboro Transit Co. vs. *Sohmer*, 237 U. S. 276, 284;
Equitable Life Soc. vs. *Pennsylvania*, 238 U. S. 143, 147;
Anderson vs. *42 Broadway Co.*, 239 U. S. 69, 72;
Fidelity and Colonial Trust Co. vs. *Louisville*, 245 U. S. 54, 59;
Doyle vs. *Mitchell Co.*, 247 U. S. 179, 182;
Ray Copper Co. vs. *U. S.* 268 U. S. 373, 376;
Macallen Co. vs. *Massachusetts*, 279 U. S. 620;
Educational Films Corp. vs. *Ward*, *supra*.

(c) A Corporation Franchise Tax Measured By Dividends or Bank Deposits or Corporate Excess Is Not a Property Tax.

A group of measurement cases that preceded the *Flint* case, and influenced the decision therein rendered, will next be considered:

Society for Savings vs. *Coite*, 73 U. S. 594:

This involved a franchise tax imposed by the State of Connecticut upon savings banks equal to three-fourths of one per cent of their deposits. Securities of the United States declared by Congress to be exempt from taxation by state authority constituted a large part of the assets of the plaintiff bank, and for that reason the tax was alleged to be invalid.

It was held, however, that the tax was not upon property, but was a valid excise imposed upon the corporation as such; that it was competent for the state legislature to levy such an excise upon the privilege of corporations doing business within the state; that it was proper to determine the tax by a measure "to be ascertained in some mode by the amount of business which the corporation shall transact within a defined period"; and that the state's power "is wholly unaffected by the fact that the corporation * * * has or has not made investment in federal securities."

Provident Institution for Savings vs. *Massachusetts*, 73 U. S. 611:

In this case the court was concerned with an excise tax imposed by Massachusetts upon savings banks measured by three-fourths of 1 per cent of their average deposits. The fact that the bank had invested in substantial amounts of Federal bonds constituted the basis of the attack upon the tax.

The tax was upheld despite the fact that the funds of the bank were largely invested in Federal bonds, the court saying:

> "The tax * * * is not a tax on the capital stock or property of the company, but upon its corporate franchise, and is not therefore subject to the objection stated by counsel, because a portion of its capital stock is invested in securities of the United States."

Hamilton Co. vs. *Massachusetts,* 73 U. S. 632:

This dealt with an excise tax imposed by Massachusetts and measured in amount by one-sixth of 1 per cent of the excess of market value of the capital stock of business corporations over the value of their real estate and machinery. The company was a large owner of Federal securities which were unquestionably reflected in the value of the company's capital stock, and for this reason the legality of the tax was put in question.

The court declared that the tax was valid, saying:

> "It is quite clear that the substantial question presented for decision is the same as that determined in the case just decided (*Provident Institution* vs. *Massachusetts,* 6 Wall. 611). * * * Property taxation and excise taxation, as authorized in the constitution of the state, are perfectly distinct, and the two systems are easily distinguished from each other, if we adopt the definition of the term 'commodities' as uniformly given by the courts of the state, and as universally understood by the taxpayers and assessors."

Home Insurance Co. vs. *New York,* 134 U. S. 594:

An excise imposed by New York upon business corporations measured by the extent of the dividends paid by the corporation during the year was resisted, on constitutional grounds, because the company derived a large part of its revenue from government bonds, and these receipts were in turn reflected in the dividends paid by the company.

It was held that the tax was a valid excise and the plan of measurement a proper one, the court saying:

> "In this case we hold, as well upon general principles as upon the authority of the first two cases cited from 6th Wallace (*Society for Savings* vs. *Coite,* 6 Wall. 594; *Provident Institution* vs. *Massachusetts,* Id. 611), that the tax * * * is not a tax on the capital stock or property of the company, but upon its corporate franchise, and is not therefore subject to the objection stated by counsel, because a portion of its capital stock is invested in securities of the United States."

(d) State Inheritance Taxes Are Valid Excises Although Measured by the Value of Nontaxables.

Upon like principle, State inheritance taxes measured by methods taking into consideration the value of nontaxable bonds of the decedent have been upheld, where the issue was the inclusion or reflection of the value of the nontaxables in the basis of measurement.

Plummer vs. *Coler,* 178 U. S. 115;
Griener vs. *Llewelyn,* 258 U. S. 384;
Blodgett vs. *Silverman,* 277 U. S. 1, 12.

(e) A Corporation Franchise Tax Measured by Capital Stock Reflecting the Value of Nontaxables Is Not a Property Tax.

Similarly, it has been held that an excise on a corporation may be measured by its outstanding stock. In the cases we cite to this effect the State law did not contain a provision for excluding nontaxables or the income therefrom from the tax base, and the issue was whether the tax was an excise or a property tax.

Hump Hair Pin Co. vs. *Emmerson,* 258 U. S. 290 (Ill.);
People vs. *Latrobe,* 49 S. Ct. 377 (New York);
International Shoe Co. vs. *Shartel,* 49 S. Ct. 380 (Missouri);
Roberts vs. *Emmerson,* 46 S. Ct. 375;
Kansas City vs. *Botkin,* 240 U. S. 227;
Western Cartridge Co. vs. *Emmerson,* 50 S. Ct. 383.

From the *Roberts* case, just cited, we quote the following:

> "The tax is imposed as a franchise tax upon a *domestic* corporation doing business only within the State. Its power to issue shares of both classes is derived from the laws of Illinois. The amount which may be issued; the manner of issue; the liability of holders of these shares and all other incidents of them, are regulated by the law of that state. The tax is not a property tax imposed on shares of stock or on the assets of the corporation. It is a tax on the corporate franchise, which includes the privilege, whether exer-

eised or not, or issuing and using when issued, a particular kind of stock known as "no-par value stock." As the stock may, under the statute, be issued for as much as $100 a share, if the company so chooses, the statute fixes the maximum extent to which the privilege may be exercised as the basis for computing the tax.

Neither this privilege nor the corresponding privilege of issuing par value stock bears any necessary relation to the value of the stock or the assets of the corporation; and the tax is imposed whether or not the stock is issued and without regard to the value of the stock or of the corporate property. * * *." (Italics ours.)

(f) A Corporation Franchise Tax Measured in Part by Net Income From Interstate Commerce Is Not a Property Tax.

Also, it has been held that an excise on a corporation may legally be measured by net income derived by the corporation from business done within the taxing state even though a part of the corporate capital is used in interstate commerce or some of its income is derived therefrom. In other words, the decisions in this group hold that a tax remains an excise and does not become a tax on property merely because some of the corporate capital located outside of the taxing state contributes to the earning of the net income by which the amount of the tax is measured, or merely because some of that net income is derived from interstate transactions. The cases to this effect are

Underwood Typewriter Co. vs. *Chamberlain*, 254 U. S. 113;
Bass, etc., Co. vs. *State Tax Commission, supra*;
Alpha Portland Cement Co. vs. *Massachusetts*, 268 U. S. 203, 216;
National Leather Co. vs. *Massachusetts*, 48 Sup. Ct. 534.

Up to this point we have cited instances of taxes held to be excises, as distinguished from property taxes, in which the basis for determining the amount of the tax was net income from business done within the taxing state, savings deposits within the taxing state, corporate excess within the taxing state, and annual dividends.

We now turn to a consideration of a number of cases involving a strict property tax, where this court, and other courts, have sustained a method for treatment of nontaxables not unlike the method with which this court was concerned in the *Flint* case.

(g) A State Tax on the Operative Property of Public Utilities Fixed at a Percentage of Gross Income From All Sources, Including Nontaxables, Is a Valid Property Tax.

Eight years after the adoption of section 1¾ of Article XIII of the California Constitution, by which State and local bonds are free and exempt from taxation, the people of this State added section 14 to that article and provided for the taxation of the operative property of certain public utilities in a percentage of the gross receipts from the operation of that property. Section 14 subdivision (a)

defines the operative property of railroad companies as:

> "their franchises, roadways, roadbeds, rails, rolling stock, poles, wires, pipes, canals, conduits, rights of way and other property, or any part thereof, used exclusively in the operation of their business in this state * * *."

Subdivision (a) of section 14 prescribes a formula whereby the gross receipts are assigned to California on a mileage prorate basis in the case of interstate operation. It is to be noted that the constitutional definition of "operative property" includes, instead of excluding, all corporate privileges and franchises and all property of every kind which makes possible the conduct of the utility business and contributes to the gross earning capacity of the operative property.

That portion of section 14 taxing the operative property of railroad companies was upheld as a property tax in the cases of

San Diego, etc., Ry. Co. vs. *State Board of Equalization,* 165 Cal. 516;

Lake Tahoe Ry. & Transportation Co. vs. *Roberts,* 168 Cal. 551;

County of San Bernardino vs. *State Board of Equalization,* 172 Cal. 76;

Southern Pacific Co. vs. *Levee District No. 1,* 172 Cal. 354;

Southern Pacific Co. vs. *Richardson,* 181 Cal. 280;

Pullman Co. vs. *Richardson* and *Walker D. Hines* vs. *Richardson,* 185 Cal. 484.

That portion of section 14 taxing the operative property of telegraph and telephone companies was upheld as a property tax in the case of

San Francisco vs. *Pacific Telephone and Telegraph Co.*, 166 Cal. 244.

That portion of section 14 taxing the operative property of companies engaged in the transmission or sale of gas or electricity was upheld as a property tax in the cases of

Pacific Gas and Electric Co. vs. *Roberts*, 168 Cal. 420; and

Pacific Gas and Electric Co. vs. *Roberts*, 176 Cal. 183.

The constitutionality of section 14 of Article XIII of the California Constitution under the commerce clause and under the due process clause of the Federal Constitution was sustained by this court in

Pullman Co. vs. *Richardson*, 261 U. S. 330,

which cited approvingly:

U. S. Express Co. vs. *Minnesota*, 223 U. S. 335; and

Cudahy Packing Co. vs. *Minnesota*, 246 U. S. 450.

The two cases last cited involved the gross receipts tax on the operative property of railroad companies under the Minnesota gross receipts tax system, and in the *U. S. Express Co.* case it was expressly urged that the taxing method was violative of the Federal

Constitution. In pronouncing the method legal this court made the very significant statement that the question,

> "in principle not unlike the one here presented came before this court in *Flint* vs. *Stone-Tracy Co.*, 220 U. S. 107."

Immediately following that statement the court proceeded to discuss and approve the measurement rule of the *Flint* case with particular reference to the matter of including interest from tax-exempts in the tax base.

The principle inherent in the method of taxing the operative property of public utilities at a percentage of their gross earnings has also been upheld in the more recent case of

> *Great Northern Railway Co.* vs. *Minnesota*, 278 U. S. 503.

In the so-called King tax bill litigation in California, which involved the 1921 increase by the Legislature of the rate applicable to the gross receipts of railroad companies from 5¼ to 7 per cent, one of the two main issues was whether the California gross receipts taxing system was consistent with the Federal Constitution in that the Southern Pacific Company, one of the contesting companies, owned valuable and extensive franchises from the Federal government.

The Federal franchises there in question comprehended grants by Congress to build and operate rail

and telegraph lines between termini within the State of California and between points within and points outside of California. It was argued that those franchises are used and operated in railroad service within California; that they have a substantial value; that their value is so blended with the value of its railroad property within the State of California that it can not be segregated from the aggregate value of its California railroad property; that the State law does not provide for such segregation of value; that in its tax report the company made no segregation; that said franchises were taxed by the State under section 14, Article XIII of the State Constitution; and that such taxation, if permitted, would abridge said franchises; would impose a burden thereon, would substantially interfere with their free use and enjoyment, and consequently that such taxation is illegal.

To that argument the State replied that the right of the Southern Pacific Company to do an interstate railroad business is in reality a Federal grant or franchise that may properly be termed the major franchise; that the franchises granted by Congress, forming the basis of the litigation, were minor franchises; that if physical property employed and engaged in the exercise of rights conferred under such minor franchises was not taxable for the reasons presented by the company, such would also be the situation in regard to the major franchise; and that if the company's contention were sound there would

be no right in a state to tax the physical property of an interstate railroad, operating within the taxing state, by the gross receipts system or by any other method of property taxation.

The United States District Court, in which the litigation occurred, sustained the State's view and held that the tax was not invalid by reason of the company's ownership and use of the Federal franchises.

Atchison, etc., Ry. Co. vs. *Collins,* 294 Fed. 742;
Southern Pac. Ry. Co. vs. *Collins,* 294 Fed. 742.

An appeal was perfected to this court but was thereafter dismissed on motion of the appellant. We quote the following from the opinion of the District Court upon the contention advanced by Southern Pacific Company:

> "It contends that the tax in question imposes a burden upon these franchises, as well as other property owned by it, and that, inasmuch as the franchises are so blended with its other property that the value thereof can not be segregated or appraised, the entire tax is void, relying chiefly upon *California* vs. *Central Pacific R. R. Co.,* 127 U. S. 1, 8 Sup. Ct. 1073, 32 L. Ed. 150. If the doctrine of this case is not impliedly qualified by later decisions of the Supreme Court, its application would seem to be confined to very narrow limits (*Chicago, B. & Q. R. R. Co.* vs. *Babcock,* 204 U. S. 585, 597, 27 Sup. Ct. 326, 51 L. Ed. 636), and in principle I am unable to distinguish the case here presented from *Western Union Tel. Co.*

vs. *Taggart*, 163 U. S. 1, 16 Sup. Ct. 1054, 41 L. Ed. 49, considered together with *Central Pacific R. R. Co.* vs. *California*, 162 U. S. 91, 16 Sup. Ct. 766, 40 L. Ed. 903, and *Chicago, B. & Q. R. R. Co.* vs. *Babcock, supra*, where the taxes assailed were held to be valid. The contention will therefore be denied."

The facts in the *Taggart* case are practically identical with those pertaining to the *Southern Pacific Company* case. It was admitted in the *Taggart* case that the value of federal franchises was included in the entire value of the property taxed, but the court said, relying upon its earlier decision in

Western Union Tel. Co. vs. *Massachusetts*, 125 U. S. 530, 141 U. S. 40:

"Those decisions clearly establish that a statute of a state, requiring a telegraph company to pay a tax upon its property within the state, valued at such a proportion of the whole value of its capital stock as the length of its lines within the state bears to the length of all its lines everywhere, deducting a sum equal to the value of its real estate and machinery subject to local taxation within the state, is constitutional and valid, notwithstanding that nothing is in terms directed to be deducted from the valuation, either for the value of its franchises from the United States, or for the value of its real estate and machinery situated and taxed in other states; unless there is something more showing that the system of taxation adopted is oppressive and unconstitutional."

The California gross receipts tax system was extended in 1926 by the addition of section 15 to Article XIII of the Constitution providing for the taxation of highway transportation companies. In terms and in effect section 15 is similar to section 14 of Article XIII.

Under section 15 of Article XIII a tax was levied on an automotive stage line. It was computed at a percentage of the carrier's gross earnings including revenue derived from carrying postal matter under a contract with the Federal Government. The inclusion of that revenue in the gross receipts tax base was alleged by the taxpayer to be violative of the due process clause of the Fourteenth Amendment and an interference with the operations of the Federal Government. Both contentions were rejected by this court.

Alward vs. *Johnson*, 282 U. S. 509.

(h) A State Property Tax on Corporate Excess, Partly Located Outside the Taxing State and Employed in Interstate Commerce, Is Valid.

Subdivision (d), section 14, Article XIII of the Constitution of California provides, as already noted, for the taxation of "corporate excess" in proportion to its value. The tax so provided for has been declared to be a property tax and has been upheld in the following cases:

Miller & Lux vs. *Richardson*, 182 Cal. 115;
People vs. *Alaska Pacific S. S. Co.*, 182 Cal. 202;

Pacific Coast S. S. Co. vs. *Richardson,* 186 Cal. 70;
Utah Construction Co. vs. *Richardson,* 187 Cal. 649;
People vs. *Ford Motor Co.,* 188 Cal. 8;
Schwab vs. *Richardson,* 188 Cal. 27.

The *Schwab* case, involving the operations of Oceanic Steamship Company, was appealed to this court and the decision of the State court affirmed (263 U. S. 88). It was held that the tax was essentially a property tax and not violative of the commerce clause of the fourteenth amendment. The issue developed from the fact that a substantial part of the value of the corporate excess was located outside of California and was employed in interstate commerce. It will be shown at a subsequent point in this brief that the value of the corporate excess tax was enhanced by the taxpayer's ownership of nontaxables, which was a characteristic of the corporate excess taxing method supplanted in 1928 by the excise here under consideration.

(i) State Ad Valorem Taxes on Shares of National Bank Stock Are Legal Though the Value of Tax-Exempts Is Included in the Assessment.

In the cases about to be cited under this head it was argued by the taxpayers that *ad valorem* taxes on National bank shares of stock which they owned were violative of the Federal Constitution and an interference with the power of Congress to borrow money on the credit of the United States in that in

the valuation of the shares no deduction was made for the value of tax-exempt securities. The court held, however, that the tax was on the shares and not on the securities, and that it was a mere incident that the value of the tax-exempts contributed to the aggregate valuation to which the taxing rate was applied.

Van Allen vs. *The Assessors,* 3 Wall. 573 (cited approvingly in *Educational Films Corp.* vs. *Ward, supra*);

Home Savings Bank vs. *Des Moines,* 205 U. S. 503;

Des Moines Bank vs. *Fairweather,* 263 U. S. 103, 114.

(j) A State Tax on Income May Properly Include in the Computation the Net Income Derived From Transactions in Interstate Commerce.

There are also cases to the effect that a state net income tax does not offend the commerce clause even though a part of the taxpayer's capital is used in or some of its income is derived from interstate commerce.

U. S. Glue Co. vs. *Oak Creek,* 247 U. S. 321, 328;
Peck vs. *Lowe,* 247 U. S. 165.

(k) A State Property Tax on Insurance Companies Fixed at a Percentage of Their Gross Premiums, With no Deductions, Is Valid.

Under subdivision (b), section 14, Article XIII of the California Constitution every insurance company doing business in this State pays, and since

1910 has paid, an annual tax on the amount of the gross premiums upon its business done in this State. The rate was originally 1.5 per cent but is now fixed at 2.6 per cent by section 3664b of the Political Code.

This tax is in lieu of all taxes and license, State, county and municipal, upon the property of such companies except county and municipal taxes on real estate. There is no provision in the Constitution or in the enabling acts for the exclusion from gross premiums of any amount estimated to be the result of the ownership by an insurance company of tax-exempt bonds. The tax has, however, been upheld as a property tax in the cases of

Hartford vs. *Jordan,* 168 Cal. 270;
Hughes vs. *Los Angeles,* 168 Cal. 764;
Northwestern Mutual, etc., Co. vs. *Roberts,* 177 Cal. 540;
Bankers Life, etc., Co. vs. *Richardson,* 192 Cal. 113.

Applying the legal principles laid down in the tax cases above cited to the California franchise tax it is evident that the California franchise tax is not a property tax but a privilege tax; that the relation of income from nontaxables to the amount of the tax is incidental; that there is no violation of the fourteenth amendment or of the commerce clause, and that the provisions in the California and Federal constitutions prohibiting the impairment of obligations of contracts are not offended.

II

SECTION 1¾ OF ARTICLE XIII OF THE CALIFORNIA CONSTITUTION IS AN EXEMPTION FROM PROPERTY TAXES ONLY; IT DOES NOT EXPRESS AN OBLIGATION TO EXEMPT THE BONDS IN QUESTION FROM TAXATION UNDER THE STATE BANK AND CORPORATION FRANCHISE TAX ACT.

Section 1 of Article XIII of the Constitution of California, as adopted in 1879, provided that

> "All property in the State, not exempt under the laws of the United States, shall be taxed in proportion to its value to be ascertained as provided by law."

An exemption was made in favor of such property

> "as may belong to the United States, this State or to any county or municipal corporation within this State."

That section was amended in 1894 to exempt free public libraries and free museums from taxation.

In that form, section 1 of Article XIII was construed by our State court to require that *all* property be taxed according to its value, except property expressly exempted. This necessarily included as taxable property corporate excess reflecting the value of bonds of all kinds, and shares of stock comprehending the value contributed to the shares by the corporate ownership of bonds of all kinds and by their increment.

Burke vs. *Badlam*, 57 Cal. 594;
San Jose Gas Co. vs. *January*, 57 Cal. 614;
Spring Valley vs. *Schottler*, 62 Cal. 69;
McHenry vs. *Downer*, 116 Cal. 20;
Bank of California vs. *San Francisco*, 142 Cal. 276.

In 1902, section 1¾ was added to Article XIII of the California Constitution providing that:

> "All bonds hereafter issued by the State of California, or by any county, city and county, municipal corporation, or district within said State, shall be free and exempt from taxation."

Prior to 1902 and at the time of the adoption of section 1¾ of Article XIII, the only State tax in existence under the law of California was a tax on property according to its value. There was no State corporation excise tax or the equivalent thereof. Section 1¾ of Article XIII, therefore, must have been adopted in the light of that situation and the only reasonable interpretation of its exempting terms is that it freed State, county and municipal bonds from the payment of property taxes. Further proof of the necessarily limited scope of section 1¾ of Article XIII is afforded by the decisions of the Supreme Court of California subsequent to 1902, from which it appears that the taxing officials, corporation tax payers and the court recognized that the exempting amendment of 1902 affected property taxes only. The proof of this lies in the fact that corporate excess, or the difference between the market value of

corporate shares and the value of the corporation's tangible property, was taxed for State purposes under the authorization of that portion of section 1 of Article XIII requiring that all "property" be taxed and defining "property" to include, among other things, "franchises."

The decisions in the *Burke, January, Spring Valley* and *Bank of California* cases, all rendered prior to the exempting amendment of 1902, were reaffirmed and followed in the case of

Crocker vs. *Scott,* 149 Cal. 575,

which was decided in 1906, and in 1916, in the case of

Bank of California vs. *Roberts,* 173 Cal. 398, 248 U. S. 476.

We quote the following from the *Crocker* case:

> "It appears too clear for question that such difference between the market value of the shares of stock and the value of the tangible property is necessarily the aggregate cash value of such intangible property as under our system must be held to belong to the corporation, call it franchise, good will, or dividend or profit-earning power, or what you please. Whatever it is, our laws positively require it to be assessed by the assessing officers to the corporation at its full cash value, precisely as all other property is required to be assessed at its full cash value."

For twenty-three years prior to 1902 and from 1902 to and including 1910, notwithstanding the exemption of bonds from property taxes in 1902, the

value of all bonds was reflected in and contributed to the amount of *ad valorem* taxes levied by the State during that entire period.

In 1910 the California Constitution was amended by adding section 14 to Article XIII. It provided for the taxation of the corporate excess of corporations generally under the misnomer "franchises" appearing in subdivision (d) of that section, and for the inclusion of "franchises" within the definition of operative property of public utilities subjected by that section to the gross receipts taxing method.

The report of the California Tax Commission of 1906 and its explanation of the term "franchises" appearing in subdivision (d), section 14, Article XIII of the Constitution, was considered by our State court in the case of

Miller & Lux vs. *Richardson,* 182 Cal. 115,

wherein it was said of the meaning of the term "franchise":

> "The theory is that the value of the company's outstanding stocks and bonds represents the value of its total assets, so that the difference between this total and the value of the company's physical properties represents the value of the company's intangible assets, and an assessment of the corporate excess, that is, of this difference, is an assessment of all the company's so-called intangibles."

"Corporate excess," the property of general corporations, made taxable by the State under subdivision (d), section 14, Article XIII, of the California Constitution, means, therefore, the difference between the aggregate value of the shares of stock, and outstanding bonds, if any, and the value of a corporation's tangible property. The proper steps in the ascertainment of the value of corporate excess, according to the *Miller and Lux* decision, are:

(1) The valuation of the corporate shares, and outstanding bonds, if any;

(2) The valuation of the corporation's tangible property, and

(3) The deduction of two from one, the difference representing the corporate excess or "franchise" to which the statutory rate or tax percentage was to be applied.

The method explained and approved in the *Miller and Lux* case does not provide for or permit of any deduction from the aggregate value of corporate shares and outstanding bonds, other than the deduction of the aggregate value of the corporation's tangible property.

Every portion of corporate capital, every piece of property, whether taxable or nontaxable, contributes to the value of corporate shares and corporate bonds. The ownership by a corporation of nontaxable bonds and their investment and manipulation by a corporation necessarily are reflected in the value of the corporate shares and bonds. It is evident, therefore,

that the value of the corporate excess was increased through the existence of nontaxable bonds and other forms of tax-exempt property.

The market value of stocks and bonds is influenced by the extent and nature of a corporation's investment in securities and by the amount of the accruals therefrom. All property owned by a corporation, including its nontaxables, produces the corporate earnings, and therefore the ascertainment of the value of the corporation's stocks and outstanding bonds by capitalization of the corporate net earnings is a method whereby the corporation's tax-exempt bonds, and the interest therefrom, affect in some degree the value of the corporate excess.

It is also of significance to note that from 1915 to 1928 there was in effect in this State a corporation license tax (Chapter 190, Statutes of 1915), which prescribed an annual charge upon corporations, other than those protected by the lieu provisions in section 14 of Article XIII, of a license tax measured by the amount of authorized capital stock, with no deductions on account of the ownership of nontaxables. This statute was adjudged invalid in its application to foreign corporations in

Perkins Manufacturing Co. vs. *Jordan,* 200 Cal. 667,

but it was valid in its application to domestic corporations according to

Roberts vs. *Emmerson, supra.*

The license tax features of this act were repealed in 1927 (Statutes of 1927, p. 396), the repeal being effective as of January 1, 1928. It is a matter of official history that the reason for this repeal was the increase of the corporate excess or franchise tax rate, in 1927, from 1.6 per cent to 1.8 per cent.

This was the general situation in 1928 when the proposal was made to add section 16 to Article XIII of the Constitution.

The addition of section 16 to Article XIII of the California Constitution in November, 1928, did not, therefore, mark the beginning of a new tax policy with respect to the treatment of interest from bonds exempt from property taxes under the amendment of 1902. The amendment of 1928 represents a *continuation* of the original policy in that regard.

Long before the adoption of the amendment of 1902, and ever since that time, the Federal Government and the states, with the approval of State and Federal courts, including our highest court, proceeded, in the structure of their tax systems, on the theory that income from bonds free from property taxes could be included in the measure of a franchise or excise tax on corporations. Presumably, the people of this State were aware of that situation in amending the State Constitution in 1902, and had they desired to extend the scope of the amendment to force the abandonment of that tax policy in this State, there would appear in the amendment some language reasonably indicating, or reasonably sus-

ceptible of the interpretation, that such was the intent of the people. The language of the amendment is conclusive that such was not the intent of the people.

Were there any doubt concerning the meaning of the amendment, that doubt, under the universal rule, would be resolved against the taxpayer, for the rule of strict construction prevails in the matter of exemptions from taxation.

Seton Hall College vs. *South Orange,* 242 U. S. 100;
Cleveland Electric Railway Co. vs. *Cleveland,* 204 U. S. 116;
Detroit United R. Co. vs. *Detroit,* 229 U. S. 44;
Milwaukee, etc., Ry Co. vs. *Rd. Com.,* 239 U. S. 174.
Vol. 24, Cal. Juris, "Taxation," par. 73, p. 89;
City of Pasadena vs. *Los Angeles,* 182 Cal. 171;
State Land Settlement Board vs. *Henderson,* 197 Cal. 470.

In the Milwaukee Ry. Co. case this court said that the surrender of a sovereign right must be evidenced by "terms so clear and unequivocal as to permit of no doubt as to their proper construction."

This court also said in the Seton Hall case:

"As the power to tax is an exercise of the sovereign authority of the state, essential to its existence, the fact of its surrender in favor of a corporation or an individual must be shown in language which can not be otherwise reasonably construed, and all doubts which arise as to the

intent to make such contract are to be resolved in favor of the state."

It is manifest, therefore, that the obligation of the State, under the amendment of 1902, was no more than that the bonds themselves were exempt from direct property tax levy, the State reserving to itself among other things the right in the future to declare that the profits or income from such bonds should become the measure of a tax to be levied on corporations for the privilege of exercising corporate functions within the State.

The buyers of bonds subsequent to 1902 had no reason whatever to assume that the obligation of the State in respect to the exempt feature of the bonds was to be extended to a degree never contemplated by the State itself, or that there would be read into the State's obligation or contract a provision contrary to the law existing at the time the obligation came into existence and in derogation of the State's power of imposing franchise taxes upon corporations for the privilege of doing business and exercising corporate functions within the State. To hold otherwise would clearly be to accord the buyers of bonds after the adoption of section 1¾ an advantage and a privilege which they had no right to anticipate or to believe would ever be accorded them.

Therefore, we submit that the language of section 1¾ of Article XIII of the California Constitution does not express or comprehend an obligation to exempt the income from the municipal bonds here in

question from inclusion in the tax base for the purpose of corporate franchise taxation under the Bank and Corporation Franchise Tax Act of 1929 and that, in consequence, no contract obligation of the State has been impaired.

We appreciate that this court has the power to decide for itself whether there is a contract and, if there is, the extent of its binding obligations, but in exercising that power and also in considering whether that power shall be exercised this court has repeatedly declared its desire to lean toward an agreement with the views expressed by the State court of last resort.

The exact and express requirements of the language used, construed *strictissimi juris* must be the limit of construction; no presumption in favor of grants of exclusive franchise or immunity from government control is indulged; the presumption is against the intent to grant; privilege can not arise from mere implication or inference; and doubts are resolved against claims of privilege.

Ford vs. *Delta Land Co.*, 164 U. S. 666;
Great Northern R. Co. vs. *Minnesota*, 216 U. S. 206;
Metropolitan St. R. Co. vs. *Tax Com.*, 199 U. S. 1;
Tennessee vs. *Whitworth*, 117 U. S. 139;
Louisiana R. Co. vs. *Behrman*, 235 U. S. 164;
J. W. Perry Co. vs. *Norfolk*, 220 U. S. 472.

In view of the absence of any clear intention in section 13 to exempt from the kind of a tax that is

set up in the Bank and Corporation Franchise Tax Act, we feel justified in assuming that this court will be inclined to accept and agree with the construction placed upon that section by our highest State court in the case at bar.

Georgia Ry. & Power Co. vs. *Decatur,* 262 U. S. 432;
Milwaukee, etc., Ry Co. vs. *Rd., supra;*
Home Tel. Co. vs. *Los Angeles,* 211 U. S. 265;
Waggoner vs. *Flack,* 188 U. S. 595.

The form of tax which this appeal presents for consideration is, relatively speaking, a new development. California could not have had it in mind as early as 1902 for at that time no such tax had been devised. Therefore, appellant is in a position where it is arguing that section 1¾ of Article XIII of the California Constitution must be read to include not only that type of tax which existed in 1902 in California—a pure property tax—but also to cover such forms of taxes as might thereafter be conceived. Stating it otherwise, appellant is maintaining that the exempting language was designed to affect not only the obligation of immunity from an existing property tax, but also immunity from contingent or speculative obligations from taxes that did not exist and were not even contemplated. This position is not maintainable under the declaration of this court,

construing section 10 of Article I of the Federal Constitution, in

Ochiltree vs. *Iowa Ry. Co.*, 21 Wall. 249,

from which we quote as follows:

> "* * * The obligation of contract within the meaning of the Constitution is a valid, subsisting obligation, not a contingent or speculative one."

III

ASSUMING, WITHOUT CONCEDING, THAT THE LANGUAGE OF SECTION 1¾ OF ARTICLE XIII OF THE CONSTITUTION OF CALIFORNIA, ADOPTED IN 1902, COMPREHENDED AN EXEMPTION FROM THAT KIND OF A TAX PROVIDED FOR IN SAID BANK AND CORPORATION FRANCHISE TAX ACT, THAT EXEMPTION WAS WITHDRAWN AND ELIMINATED BY SUBSEQUENT CHANGES IN THE CALIFORNIA CONSTITUTION.

Prior to the constitutional amendment of 1902 under which appellant is here claiming tax exemption California was committed by the terms of its Constitution (section 1 of Article XIII) not only to the *ad valorem* system of taxation, but to the requirement of uniformity in tax treatment under that method.

In 1910 that rigidity was broken by an amendment to section 1 of Article XIII to the effect that all property should be taxed in proportion to its value

"except as otherwise in this Constitution provided," and by the addition to Article XIII, consistently with the quoted language introduced into section 1 of that article, of a new section numbered section 14. Assuming that section 1¾ of Article XIII was intended, when adopted, to include within its reach those forms of taxes, other than strictly property taxes, where the amount of the imposition was affected in any degree by the taxpayer's ownership of bonds immune from direct taxation or by the profits or interest accruals from such bonds, the necessary effect of section 14 of Article XIII was to curtail such intendment of section 1¾ and to limit its effect to property taxes only.

Such was the necessary effect of section 14 upon section 1¾ of Article XIII in view of the provisions of section 14 taxing the operative property of utilities on their *gross* receipts, insurance companies upon their *gross* premiums, general corporations upon their corporate excess, and State and National banks upon the value of their shares of capital stock. The ownership by those taxpayers of bonds exempt from direct property taxes was, as hereinabove demonstrated, a contributing factor, to some degree, in the amount of the taxes paid to the State by all of those taxpayers.

If there were any doubt concerning the alleged effect of the amendment of 1910 to Article XIII of the California Constitution all such doubt was definitely dispelled by the amendment of 1928 and the

enabling legislation enacted in conformity therewith. Section 14 was thereby changed, as already noted, to eliminate the property tax on State and National bank shares of capital stock and to eliminate the corporate excess tax, also a property tax, and to substitute in lieu thereof, a pure franchise or excise tax by which all banks and all corporations other than utilities and insurance companies, were required to pay to the State a tax, for the privilege of operating within the State, measured in amount at the rate of 4 per cent of their net income from all sources arising out of business done in California.

We do not concede that section 1¼ of Article XIII was ever intended to exempt bonds from any tax other than the direct, old-fashioned property tax, nor do we concede that section 16 of Article XIII or the Bank and Corporation Franchise Tax Act enacted under the permission and direction of section 16, were intended to strike at interest from bonds exempt from the imposition of property taxes under section 1¼ of Article XIII, but upon the assumption that section 1¼ had a wider range than that which we attribute to it, it is obvious that the superimposition of sections 14 and 16 of Article XIII upon section 1¼ of that article restricts the exemption of section 1¼ to property taxes only.

It can not be disputed that a state has the right to change its tax policy or any policy reflected in its legislation. To assert that a policy, once adopted, becomes immutable is to assert that imperfection

and errors in legislation become constitutional rights." Such an assertion would be "a narrow conception of sovereignty." A state is free to forsake any policy after its experience has proved that the policy is injudicious and should be abandoned. "An exercise of public policy can not be resisted because of conduct or contracts done or made upon the faith of former exercises of it upon the ground that its later exercises deprive of property or invalidate those contracts."

Thornton vs. *Duffy*, 254 U. S. 361 (369);
Ochiltree vs. *Iowa Ry. Co.*, 21 Wall. 249, 253.

IV.

THE CASE OF MACALLEN VS. MASSACHUSETTS IS NOT CONCLUSIVE OR CONTROLLING

It is our contention that the cases cited under heading I of this brief establish the correctness of the judgment herein appealed from, and that there is nothing in *Macallen* vs. *Massachusetts*, *supra*, upon which decision appellant places its entire reliance, to demand a reversal of that judgment.

(a) Analysis of Macallen Decision.

Macallen vs. *Massachusetts* involved the Corporate Franchise Tax Act of Massachusetts. The statute made the amount of the tax dependent upon a percentage of the corporate excess and upon a percentage of corporate net income derived from business carried on within the State. We are here concerned with the latter feature only.

The term "net income" as defined in the Massachusetts act, prior to its amendment in 1925, *expressly excluded* interest from nontaxable bonds. In 1925 the act was amended, and concededly the sole purpose and effect of the amendment was to carry out the recommendation of the Massachusetts Tax Commission that interest from all nontaxable bonds be included in the "net income" which should serve as the base in the calculation of a portion of the tax.

Prior to 1925, income from nontaxable securities was not included or reflected *in any tax base* for the purpose of assessing franchise taxes against corporations, and prior to that year, the income from Federal, State and local bonds, as well as the bonds themselves, was exempt from taxation in Massachusetts by statutory provision.

The report of the Massachusetts Tax Commission recommending the amendment of 1925 frankly stated that *the purpose of the proposal* was to include in the tax base the income from tax exempts which theretofore had been expressly excluded. It also said:

> "Business corporations held tax-exempt securities generally not because they fit into the purpose of their organization, but for the bearing they may have upon tax payments."

This court deemed itself confronted with:

> "A distinct change of policy on the part of the Commonwealth, adopted, as though it had been

> so declared in precise words, for the general purpose of subjecting such securities *pro tanto* to the burden of the tax."

For confirmation of its view in that regard this court referred to the Tax Commission's Report and said of it:

> "The effect of the report is that nontaxable bonds nevertheless should be subjected to the burden of the tax; and, since that could not be imposed directly, the clear intimation is that it be imposed indirectly through the medium of the so-called 'excise'."

With this situation before it this court concluded that the history, form and purpose of the amendment of 1925, together with its surrounding circumstances were such as to *compel* the court to hold that the Commonwealth was in fact and in reality aiming at and seeking to burden a nontaxable subject in computing part of the tax payable by Macallen Company by net income which included income from tax-exempt bonds owned by the company.

Having held that the tax was *upon the income* in question it followed that the tax was upon nontaxable property. Having concluded that the levy in controversy was a *property tax upon nontaxable property* this court necessarily held that there was a direct burden upon instrumentalities employed by the Federal Government in the exercise of its constitutional power to borrow money on the credit of the United States.

The other necessary corollary of this court's conclusion that the tax was cast *upon nontaxable property* was that the Massachusetts statute violated those acts of Congress declaring the Federal securities to be nontaxable, and violated, as to the local bonds, provisions in the State and Federal Constitutions prohibiting the impairment of the obligation of contracts.

The decision in *Flint* vs. *Stone-Tracy Co., supra,* was the cornerstone in the defense of the Massachusetts statute. Although the decision was adverse to the commonwealth, it is obvious that the refusal of this court to decide the case upon the authority of the *Flint* decision was due to the circumstances, above detailed, leading to the enactment of the amendment of 1925. This court did not repudiate the doctrine or the principle in *Flint* vs. *Stone-Tracy Co.,* nor did it expressly or impliedly narrow or qualify the same. The court did refer to the *Flint* case as "the extreme example" of those decisions sustaining the legality of taxes imposed upon the exercise of corporate privileges measured by income including income from nontaxable property, but, nevertheless, there appears to be no recession from the position taken by this court in the *Flint* case. Further, this court cited, without a word of disapproval or limitation, its former decisions in the *Home Insurance Co., Society for Savings,* and *Provident Institution* cases, *supra.*

The explanation of *Flint* vs. *Stone-Tracy* discloses the reason for the reversal of the decision of the Massachusetts court. The relation of interest from nontaxables to a state-taxing statute which imposes a charge upon corporations for the privilege of exercising their franchises in the taxing state and measures that charge according to the net income derived from business done within the taxing state must be "fortuitous" and "incidental." Because of the circumstances peculiar to the enactment of the 1925 tax amendment by the Massachusetts Legislature, this court felt compelled to hold that Massachusetts was not therein dealing fortuitously or incidentally with interest from nontaxables but was dealing with them deliberately, *dealing with them alone,* and attempting to do that which it deemed itself powerless to do otherwise and had not theretofore done, directly or indirectly, in taxing corporations.

This court was faced, it believed, not only with a radical change of policy on the part of Massachusetts but with evidence (in the Tax Commission Report), of a single purpose by the State to subject the securities *"pro tanto"* to the burden of the tax.

Appellant's observation that a rehearing was denied by this court in the *Macallen* case, despite the efforts of legal representatives of a number of states, "including California" is perhaps intended to convey the impression that California presented *its* case to this court and that the denial of the rehearing is an indication that California stands in the same

position as Massachusetts. Whatever is appellant's purpose in this connection, the fact is that when California joined with other states, as friends of the court, in requesting that the *Macallen* case be reheard, its interest was that the integrity of the doctrine of *Flint* vs. *Stone-Tracy* be preserved intact.

In participating in the *Macallen* case California explained why it was interested in the case; admitted that California relied upon the *Flint* case in adopting section 16 of Article XIII of its Constitution, and observed that the Congress, the State of New York, the American Bankers' Association and the National Tax Association all have relied upon the *Flint* case, and that presumably Massachusetts relied upon the *Flint* case in making the franchise tax change of 1925.

The essence of California's brief in the *Macallen* case is expressed in the following quotation therefrom:

> "If the opinion already rendered herein stands as the law of the case, and is intended to repudiate the declaration in the *Flint* case with respect to the treatment of interest from tax-exempt securities in calculating the amount of a corporate franchise tax, then California is vitally affected."

California did not assert or even suggest that the *Macallen* decision, if allowed to stand, would establish the invalidity of the California act. This court doubtless concluded that its opinion was sufficiently clear to disclose that the court did not intend to

repudiate the doctrine of the *Flint* case and that the decision was not intended to go beyond the unique circumstances involved in the *Macallen* case.

(b) California's Tax Policy in Its Treatment of Tax-Exempts and Its Purpose in Enacting the Legislation Here in Question.

(1) California's Policy Toward Corporations Between 1879 and November, 1928.

In order not unduly to prolong this brief we invite the attention of the court, at this point, to the tax situation of corporations in California between the years 1879 and 1902, and between the year 1902 and the end of 1928, which we have discussed under our heading II.

Summarizing that discussion, it is there established that for practically fifty years preceding the effective adoption of section 16 of Article XIII of the California Constitution there existed in California a system of State taxation of property whereby every corporation, whether a public utility, a bank, or a general business corporation, paid to the State an annual tax to the amount of which there was an indirect contribution resulting from the ownership by the corporation of Federal, State and municipal bonds immune from direct taxation, as well as from the ownership of all other kinds of bonds and every element of value comprehended in corporate capital.

The decisions of the Supreme Court of California disclose that the court experienced no difficulty in determining the State's tax policy toward corporations during that fifty-year period. The court found that language to be clear and unequivocal. (Only in a case where the language of an enactment is ambiguous will courts consider and be influenced by administrative interpretation as explained by an administrative officer or board.)

These statements are not mere theory but are based upon uniform, consistent administration of the State property tax on corporations during that fifty-year period, and upon decisions we have cited herein involving various features of that system.

(2) The Opinion of the State Board of Equalization in the Vortox Case.

It would be futile for appellant to challenge any of those decisions and appellant does not undertake to do so. Against the clear holding of those decisions appellant urges upon this court the opinion of the State Board of Equalization of California, an administrative body, claiming that it overcomes that which appellant presumably anticipated we would say of California's tax policy between 1879 and 1928.

Assuming that the opinion of the State Board of Equalization, appended to appellant's brief, is entitled to any consideration, the opinion does not express the view that interest accruing upon bonds exempt from property taxes is not reflected in the

amount of State tax payable by a corporation, such as appellant, prior to the adoption in 1928 of section 16, Article XIII of the California Constitution, and appellant does not argue that the opinion so states.

That opinion not only fails to set forth the history of the Bank and Corporation Franchise Tax Act comprehensively but fails accurately to relate the history of the statute. It reveals a misconception of the corporate excess, or "franchise," tax which has been supplanted by the excise provided for in paragraph 2a of section 16 of Article XIII of the Constitution.

Particularly, the opinion states that the practice of the State Board of Equalization, the body charged by law with the administration of the corporate excess tax, was to exclude the value of all tax-exempt property in the calculation of the corporate excess tax.

The California court squarely held in *Miller & Lux* vs. *Richardson, supra,* that by "corporate excess" is meant the difference *between* the aggregate value of the shares of stock, and outstanding bonds if any, and the value of the corporation's tangible property. In that case the court definitely held that the proper steps in the ascertainment of the value of corporate excess are (1) the valuation of the corporate shares, and outstanding bonds if any, (2) the valuation of the corporation's tangible property, and (3) the deduction of (2) from (1), the difference representing the corporate excess or

"franchise" to which the statutory rate was to be applied. An apportionment or allocation of the corporate excess, to determine the value of the aggregate corporate excess situated within California, was necessary in a case where the corporation did business outside of California or engaged in interstate commerce.

People vs. *Ford Motor Co., supra;*
Schwab vs. *Richardson, supra.*

Notwithstanding the explicit exposition of the corporate excess tax by the California court, the opinion of the State Board of Equalization in the *Vortox* case declares that the value of tax-exempt property of corporations was not reflected in the value of corporate excess as ascertained by that board. Therein it is expressly stated that the corporate excess law "did not contemplate that the franchise value of corporations would be increased through their ownership of exempt property."

Regardless of the form of report of a taxpayer subject to the old corporate excess tax, and regardless of the data so reported, there was but one course for the State Board of Equalization to pursue in the assessment and levy of the corporate excess tax. Corporate excess was the equivalent of "franchise," in the opinion of the court in *Miller & Lux* vs. *Richardson, supra,* and the method therein pointed out for ascertaining the value of corporate excess does not permit of *any* deduction from the aggregate value of

the corporate shares and outstanding bonds other than the deduction of the aggregate value of the tangible property.

Assuming that appellant had been subject during the tax year here in question to the old corporate excess tax law instead of to the Bank and Corporation Franchise Tax Act, which superseded it, the procedure which would necessarily have been followed by the State Board of Equalization in arriving at the value of appellant's corporate excess would have been as follows: First the board would have placed a value upon appellant's shares of stock and upon any bonds of its own issue that may have been outstanding. In making that appraisal the board would have been obliged to take into consideration all assets of the corporation, including nontaxable property. The next step would have been to value all tangible property of the corporation and if that value was less than the value found in the first step of the process, to have then subtracted the value of the tangible property from the value of the stock and bonds. The difference between those two values would have been the corporate excess and to the amount of that corporate excess, without any further deduction, the statutory rate or taxing percentage would have been applied and the result of that computation would have produced the amount of tax payable by the corporation.

Thus it is apparent that such contribution as tax-exempt bonds and their incidence made to the value

of the corporation's shares and bonds of its own issue was not entirely eliminated by the mere deduction of the value of the corporation's tangible property.

The opinion of the State Board of Equalization does not dispute that the administration of the corporate excess tax was other than that which the decisions established it to be, but that opinion does indicate a misapprehension and lack of understanding of the position taken by the Franchise Tax Commissioner in applying the terms of the Bank and Corporation Franchise Tax Act to Vortox Manufacturing Company.

(3) The Reasons for the Constitutional Amendment of 1928 and for the Enactment in 1929 of the Bank and Corporation Franchise Tax Act.

The California Tax Commission of 1927 was created for the sole purpose, expressed in the act establishing the Commission (Chapter 455, Statutes of California for 1927; p. III of Final Report of the Commission, filed herein by appellant), of investigating the system of revenue and taxation in force in California and specially to report upon the matter of the relative burden of taxes borne by property under the existing State and local systems.

It merely *happened* that the Commission was available for action when the emergency arose in California in 1927 whereby it appeared that the State's tax on all banks was doubtless invalid and that the State was faced with a potential loss of $22,000,000 within a period of five years, or with the alternative

of permitting banks to go untaxed, if steps were not immediately taken to correct the situation.

Appellant has seized upon fragments of the reports of the Commission and has sought to paint to this court a picture of a deliberate movement by the State, commencing with over a year of painstaking investigation by a carefully and expensively assembled tax staff, followed by a special report of that staff and that Commission in August, 1928, and culminating in a call by the Governor for the convening of the State Legislature in extraordinary session, in the proposal of a constitutional amendment at that session and in the submission of that proposal to the people of the State and in their ratification of it at the general State election in November, 1928, every step of which, according to appellant, had as its ultimate objective the setting up of a tax scheme for the taxation of tax-exempt bonds owned by banks and commercial corporations. The bare description of appellant's picture of the situation refutes the existence of any such State program. For a State to employ such extraordinary measures for the accomplishment of such a minor result is so unreasonable, and so lacking in intelligence, that it is incredible that this court will seriously regard appellant's insistence that California's "major purpose" was to subject interest from tax-exempt bonds to the treatment here complained of.

The method pursued by the State of California differs so sharply from the course taken by the State

of Massachusetts that the inapplicability of the *Macallen* decision to the case at bar seems patent. California had as its objective the duty and purpose of remedying a vital defect in its State tax system, which, from the standpoint of a fair distribution of tax burden, as well as from the standpoint of the integrity of the State's revenue, demanded correction. That defect did not involve in any sense, or in any degree, the matter of tax treatment of so-called tax-exempts. The proof positive of this statement is to be found in the very letter of section 16 of Article XIII of the California Constitution.

Should this court, nevertheless, deem it necessary to inquire into the official background of that provision of the Constitution, there also will be found equally conclusive proof that California did not amend its Constitution, following a summary call of its Legislature, merely to substitute for a system where tax exempts indirectly figured in the amount of general corporation taxes another plan of taxation whereby interest from tax-exempt bonds would be reflected in the amount of the taxes payable to the State by general corporations. The duty which the State owed to itself and to all of the taxpayers of the State could not have been performed, and the fundamental defect in the State tax structure could not have been remedied by a course calculated only to effect such a substitution of method.

The Constitution of California had to be amended to remove the exemption of mortgages from taxation

and to eliminate or extend the provision in section 1 of Article XIII for the deduction from credits of debts due to bona fide residents of this State, which would have enabled the State to retain its tax on the shares of National and State banks, or the State had to abandon the share tax on banks and move to some of the other methods authorized by section 5219 R. S.

The special report of the California Tax Commission showed that National and State banks were grossly overtaxed by the then existing system of taxing their shares of stock. Expressing their tax burden in terms of percentage of net income, their tax rate was 11.8 per cent as compared to an average tax rate borne by general corporations of 4.4 per cent when translated into terms of percentage of net income (p. 270–1, Final Report of Commission).

The report found that if National and State banks were moved to the fourth method permitted by the act of Congress and a 4 per cent rate applied, their tax burden would be reduced about sixty per cent, and they would thereby be in a much preferred tax situation as compared with general corporations.

The discussion on pages 270 to 277 of the Final Report shows the interest of the commission not only in having the State system placed upon a clearly legal basis, but in having the State adopt a plan which would equalize, as far as possible, the tax burden and remove the gross disparities then existing not only between banks on the one hand and general

corporations on the other, but within that great group of general corporations then subject to the corporate excess tax.

Had the commission recommended, and had the State adopted, the second method sanctioned by section 5219 R. S., the amount of revenue collectible from National and State banks would have been negligible, and from a situation of extreme discrimination against the banks the State would have moved into a situation of extreme discrimination in favor of the banks and against general corporations.

Had the commission recommended, and had the State adopted the third method offered to the states by the Federal act it would have been necessary for the State to enact an income tax act. Such a move would have required a radical change in the entire tax structure of the State which, since 1910, has involved a separation of sources of taxation as between the State and lesser political subdivisions, and it would have had the further result of increasing the disparity of the respective State tax burdens of banks and general corporations. The State, as the commission's report, the Governor's communications to the legislators, and the official explanation of the proposed constitutional amendment of 1928 to the people of the State disclose, was not interested in obtaining *more tax revenue* than had been theretofore yielded by its tax system. It was interested only in maintaining the integrity of its tax revenues by the necessary major changes in its tax system,

and in the making of those changes it was desirous, having at least a limited opportunity at hand created by need for major revision, of equalizing the tax burden among corporations and as between banks and corporations of producing a fairer spread of the tax load. More revenue at the moment or in the years immediately ahead did not concern the State of California, which in 1928 had a surplus of over $20,000,000 and in 1929, before the tax change of 1928 had been put into effect, had a surplus of approximately $30,000,000 (p. 118 Biennial Report of the State Controller of California, 1929–30).

It can not reasonably be contended that California abandoned the share tax on banks in order to set up a franchise tax system whereby interest from tax exempts would be included in the tax base. The only logical and fair explanation of why the State moved off of the bank-share taxing method is because it recognized the soundness and the popularity of the exemption of mortgages from taxation, and of a low rate of taxation on intangibles such as stocks and bonds and solvent credits.

Viewing the matter fairly and in its larger aspects, as appellant seemingly has not done, it can not reasonably be contended that the State failed to change from the bank-share tax method to the method of taxing dividends from bank shares merely to accomplish the inclusion of interest of tax exempts in the tax base under a franchise tax plan. The only logical and fair explanation of the State's decision not

to adopt the second method authorized by section 5219 R. S., is because the adoption of that method of taxing National and State banks would have meant virtual tax immunity for the banks, a situation which the State did not regard as desirable from any standpoint.

Nor can it reasonably be contended that the State failed to move banks from the share-tax method to a method whereby they were taxed *on* their net income merely for the purpose of including interest from tax exempts in the base of a tax which is not a tax on income but a tax for the privilege of exercising corporate privileges measured in amount by net income arising from corporate business done within the taxing State.

The only logical and fair explanation of the decision by the State to adopt the fourth method permitted by section 5219 R. S. instead of the third method therein held out to the states is because California had no income tax, would have had to enact an income tax, would have encountered widespread opposition to an income tax proposal and possibly would not have succeeded in enacting it into law. Ever since 1879 the Constitution of California has authorized the Legislature to provide for an income tax of any kind, but that delegated authority has never been exercised. (Section 11, Article XIII.) It was imperative that the commission recommend and that the State adopt a plan which would be legal and a plan which the voters of the State and the members

of the State Legislature would approve. There was no time for experiment or for delay, and the State was in no position to take any chances either with legal questions or with the temper of its people and its legislators. (Pages 94 to 101, Final Report.) Those are the real reasons for the commission's recommendation of the fourth method as against the third method in section 5219, R. S. No one of them is even mentioned or suggested by the appellant. Appellant would have this court believe that the selection of the fourth method instead of the third method was attributable to the existence of large quantities of tax-exempt bonds held by taxpayers. There is nothing in the Governor's message to the legislators summoning them into special session, nothing in the draft of the constitutional amendment proposed by the commission to the Legislature, nothing in the constitutional amendment determined upon by the Legislature for submission to the people of the State at the general election in November, 1928, and nothing in the official statement concerning the proposal distributed to every voter in California, which indicated that the State was concerned with a new method of treating interest from tax-exempt bonds, or that interest from tax-exempt bonds even figured in the proposal.

Reverting to what the commission did say in its report concerning holdings of tax-exempt bonds, it is to be noted that the reference thereto is applied only to banks. It would have been "serious" in one sense

had the commission recommended the third method as against the fourth method in section 5219, R. S., but the seriousness would not have resided in the fact that the State would thereby have obtained less revenue than it needed or desired. The situation would have been serious because, as already explained, there was a tremendous advantage for the banks to be relieved from the share tax and placed under an income tax or under a franchise tax, and the commission deemed it unwise and unfair from the point of view of equity and success in having its recommendations approved by the people and by the Legislature, not from the point of view of additional revenue, to recommend the fourth method as contrasted with the third. Appellant does not call the attention of the court to the statement by the commission that "in the case of corporations other than banks" it is "not of vital importance" whether or not interest from tax exempts is included in the tax base. (Page 276, Final Report.)

At the time the Commission prepared in special report in August, 1928, the *Macallen* case was pending, and at that point of the report just noted reference to that case is made. The presence of that reference in the report can not be reconciled reasonably with appellant's claim that by indirection and guile California sought indirectly to accomplish, by an ingenious scheme for treating tax exempts, that which it could not do directly under some other tax plan. The same comment may be made of the sug-

gested form of constitutional amendment submitted by the Commission to the Governor of California and by him in turn to the Legislature sitting in extraordinary session, for in paragraph (5) thereof it is provided that the Legislature shall define net income, including "if possible" the entire net income received from all sources. (Page 290, Final Report.) From this it is plain that the purpose of the Commission was not to effect a new, artful and indirect method of taxing interest from tax exempts. Had such been the purpose of the Commission, the language of its proposed constitutional amendment would have directed that net income be defined to include income from all sources. The amendment which the Legislature proposed, and which the people adopted, subsequent to the Commission's recommendation, likewise did not compel the inclusion of interest from tax exempts in the tax base. The language thereof is that the Legislature shall define net income, and that it "may" define it to include "the entire net income received from all sources." Again, if the major objective of the Commission, or of the Governor, or of the Legislature, or of the people of California, had been to set up a plan of franchise tax whereby interest from tax exempts would be comprehended within the net income base, the language of the constitutional amendment would have been positive and mandatory in that regard, and the Legislature would not have been left free, as it was, to exercise its discretion as to whether that

interest should or should not be included in the tax base. Appellant, therefore, can derive neither comfort nor support from the language of the Commission, even if this court should be inclined to look behind the language of the Bank and Corporation Franchise Tax Act of 1929.

The Legislature of California meeting in regular session in 1929, immediately following the adoption of section 16 of Article XIII of the California Constitution, can not, therefore, be said to have acted upon any constitutional *direction* in constructing the Bank and Corporation Franchise Tax Act, for section 16 of Article XIII contains no such direction. Nor can it fairly be said that the Legislature, in so acting, followed any positive or definite *recommendation* of the Commission. For reasons already discussed fully, the Commission expressed its *preference* for the fourth method in section 5219 R. S., as compared with the third method therein authorized, but when it came to a concrete proposal and recommendation to the Legislature in the form of a suggested constitutional amendment it left open the matter of the scope of the base by which the franchise tax should be measured. When the proposal, modified by the Legislature, and transformed by the people into an integral part of the Constitution, demanded legislative action, the Legislature was entirely free in the matter of dealing with interest from tax exempts, and it elected to establish a base comprehending income from all sources including bonds

of all kinds, but in doing so it exercised, unhampered, its own discretion, and its motive or purpose in acting as it did act can not fairly be attributed to events preceding the enactment of the statute.

There were the suggestions of the Commission for the consideration of the Legislature. It was stated to the Legislature by Dr. Robert M. Haig, Adviser and Director of Research of the Technical Staff, cooperating with the California Tax Commission of 1927, that interest from tax-exempt bonds is an exceedingly important item in a tax which is applied to banks; but, as already observed, that statement was not predicated upon any positive recommendation of the Commission or upon any direction in the matter by the constitutional amendment to the Legislature; and, in addition, the statement was applied to banks only, and that for the reasons hereinabove discussed, and not to general corporations of the class in which appellant is embraced. Of far greater importance, however, is the fact that there was before the Legislature for consideration a long line of decisions of this court, appearing definitely to establish the validity of that feature of a pure franchise or corporation excise tax which measures the amount of the imposition by a percentage of a net income base in which is included interest from tax-exempt bonds and other bonds of all kinds.

Society for Savings vs. *Coite*, 6 Wall. 594, *supra*;

Provident Institution vs. *Massachusetts*, 6 Wall. 611, *supra*;
Hamilton Co. vs. *Massachusetts*, 73 U. S. 632, *supra*;
Home Insurance Co. vs. *New York*, *supra*;
Flint vs. *Stone-Tracy*, *supra*;
McCoach vs. *Mineville Ry. Co.*, 228 U. S. 295, 387 (1913);
Stratton's Independence, Ltd. vs. *Howbert*, 231 U. S. 399, 416 (1913);
Interboro Transit Co. vs. *Sohmer*, 237 U. S. 276, 284 (1915);
Equitable Life Soc. vs. *Pennsylvania*, 238 U. S. 143, 147 (1915);
Anderson vs. *42 Broadway Co.*, 239 U. S. 69, 72 (1915);
Fidelity and Colonial Trust Co. vs. *Louisville*, 245 U. S. 54, 59 (1917).
Doyle vs. *Mitchell Co.*, 247 U. S. 179, 182 (1918);
Ray Copper Co. vs. *U. S.*, 268 U. S. 373, 376 (1925).

With this explanation and statement of California's tax policy toward corporations for fifty years prior to November, 1928; of the reasons and purposes underlying and leading up to the change effected in the Constitution of California by the addition of section 16 to Article XIII in November, 1928, and of the situation confronting the Legislature of California when it enacted the statute here under attack, we can say, as we do say to this court in perfect conscience, that the provision in the Bank and Corporation Franchise Tax Act of 1929 for the

inclusion in the tax base of the interest from the bonds here in question was merely "fortuitous" and "incidental" to the main purpose of that statute and of its parent provision in the organic law of the State, namely, section 16 of Article XIII.

IV

Educational Films Corporation vs. Ward

This brief would be incomplete without some reference to *Educational Films Corporation* vs. *Ward*, 282 U. S. 379.

Without that case our position would be the same, inasmuch as we contend that our case is governed by the principles in *Flint* vs. *Stone-Tracy* and not by the *Macallen* case. Nevertheless, there is a close parallel between our case and the *Films* case and between the California tax situation and the New York tax situation and the *Films* case undoubtedly lends added strength to our position. It distinguishes the *Macallen* case and leaves no doubt as to the precise basis of that decision. The *Films* case also removes any doubt that may have existed as to *Flint* vs. *Stone-Tracy* being overruled, and establishes the principles of that case more firmly than ever.

The *Films* case involved a New York statute providing for an annual tax on domestic corporations for the privilege of exercising their franchises in the State in a corporate or organized capacity. The tax is payable in advance for each year and is at the

rate of four and one-half per cent of so much of the corporation's entire net income for its preceding fiscal year as is, under other sections, allocated to the business carried on within the State. Under the statute net income embraces "income from any source" and "is presumably the same as the entire net income" reported for income taxation to the United States "plus * * * dividends on stocks or any interest received on bonds of any character."

Subdivision 3 of section 208 of the statute provides "the term 'entire net income' means the total net income, including all dividends received on stocks, and all interest received from Federal, State, municipal or other bonds * * *."

The plaintiff in that case was the owner of copyrights granted by the United States upon motion picture films and had received royalties for the licensing of them. The company contended that the tax was invalid on the ground that the copyrights and all income derived from them were immune from State taxation and that the tax measured by net income was void so far as the measure included income from the copyrights, because it constituted a tax on Federal instrumentalities.

The question of contract between the State and the taxpayer was not involved, but it is readily apparent that in other particulars the case affords a close parallel to the case at bar. This is made apparent by what was said by this court in its opinion upholding the New York statute and declaring the

tax to be valid. This court held, as we ask the court to hold in this case, that the tax was not a direct tax upon allocated income of a corporation in a given year, but a tax for the privilege of doing business in one year measured by the allocated income accruing from the business in the preceding year. In that connection this court said:

> "If we look to the operation of the present statute, it is plain that it can have no application independent of the corporation's enjoyment of the privilege of exercising its franchise. * * * Since it can be levied only when the corporation both seeks or exercises the privilege of doing business in one year and has been in receipt of net income during its preceding fiscal year, the tax, whatever descriptive terms are properly applicable to it, obviously is not exclusively on income apart from the franchise."

This court, referring to *Flint* vs. *Stone-Tracy* and allied cases, including *Society for Savings* vs. *Coite*, then said that it has been consistently held that the privilege of exercising a corporate franchise is no less an appropriate object of taxation by one government merely because the corporate property or net income which is made the measure of the tax may chance to include the obligations of the other or the income derived from them, and that the constitutional power of one government to reach this permissible object of taxation may not be curtailed because of the indirect effect which the tax may have upon the other. The court then mentioned other

forms of excise taxes which have been upheld upon like principles, although the statutory measure of the tax included securities constitutionally immune from any form of direct taxation. Among the other forms referred to were a State inheritance or legacy tax, although measured by the value of the United States bonds which are transmitted (*Plummer* vs. *Coler,* 178 U. S. 115); an inheritance tax levied by a State on a bequest to the United States (*U. S.* vs. *Perkins,* 163 U. S. 625); an inheritance tax by the United States on a bequest to a municipality (*Snyder* vs. *Bettman,* 190 U. S. 249); State laws, taxing to stockholders at full value shares in National banks, although the banks own tax-exempt United States bonds (*Van Allen* vs. *Assessors,* 3 Wall. 573); the tax on net income, including receipts from exports in the computation of the income (*Peck & Co.* vs. *Lowe,* 247 U. S. 165); a State income tax on income, including income from interstate commerce (*United States Glue Co.* vs. *Oak Creek,* 247 U. S. 321); a State tax upon the franchise of a corporation measured by its receipts from transportation properly apportioned to the business done within the State, although it includes receipts from interstate commerce (*Maine* vs. *Grand Trunk Ry. Co.,* 142 U. S. 217); a tax on franchises of domestic corporations measured by corporate property, even though such property be without the State (*Kansas City Ry.* vs. *Kansas City,* 240 U. S. 227).

Referring to the last mentioned type of tax this court said:

> "So well settled is this last mentioned application of the doctrine that an excise may be measured by tax immune property, that an appeal in which such a tax was assailed on the very grounds urged here, was dismissed *per curiam* during the present term. No. 108, *Nebraska ex rel. Beatrice Creamery Co.* vs. *Marsh,* decided Oct. 20, 1930."

Further quoting from the *Films* case it was said by this court:

> "It is said that there is no logical distinction between a tax laid on a proper object of taxation, measured by a subject matter which is immune, and a tax of like amount imposed directly on the latter; but it may be said with greater force that there is a logical and practical distinction between a tax laid directly upon all of any class of government instrumentalities, which the Constitution impliedly forbids, and a tax such as the present which can in no case have any incidence, unless the taxpayer enjoys a privilege which is a proper object of taxation, and which would not be open to question if its amount were arrived at by any other nondiscriminatory method. * * *
>
> Having in mind the end sought, we can not say that the rule applied by this court for some 70 years—that a nondiscriminatory tax upon corporate franchises is valid, notwithstanding the inclusion of tax-exempt property or income in the measure of it—has failed of its purpose, or

has worked so badly as to require a departure from it now; or that the present tax, viewed in the light of actualities, imposes any such real or direct burden on the Federal Government as to call for the application of a different rule."

This court then proceeded to distinguish the *Macallen* case, showing that the decision in that case was rested "on the distinguishing fact that the tax-exempt securities were included in the measure of the franchise tax by virtue of an amendment to the taxing statute, which, it was held, was specifically intended to reach the income from tax-exempt national and municipal bonds which has previously not been included in the measure of the tax."

This court then said that the case was thus brought within the purview of

Miller vs. *Milwaukee*, 272 U. S. 713,

where it was held that:

"If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail, even if but for its purpose or special operation it would be perfectly good."

And the court qualified that statement as, in fact, it had been qualified in the *Macallen* case, by saying (quoting from the *Miller* case):

"A tax very well may be upheld as against any casual effect it may have upon the bonds of the

United States when passed with a different intent and not aimed at them."

In the *Films* case the court held that before the New York statute was amended its was sufficiently broad to include income from copyrights within the measure of the tax and that neither before nor after the amendments did it make any mention of copyrights or their income and that there was nothing to suggest that the Legislature could at any time have had in mind the addition of income from copyrights to the measure of the tax, or that the statute or the amendments thereto had been adopted for the purpose of subjecting it *pro tanto* to the burden of the tax.

Thus was the *Films* case distinguished from the *Macallen* case and for like reasons and upon like principles we respectfully urge that the case now at bar may be even more readily distinguished from the *Macallen* case. In view of the history of the California legislation, to which we have herein made extended reference, we believe that this court can not fail to be convinced beyond any shadow of a doubt that California had no "major purpose" to strike at nontaxable bonds or the income therefrom; that there existed on the part of California, its people, or its Legislature, no ulterior or sinister motive such as would invalidate its legislation, but that quite to the contrary the treatment of tax exempts was but incidental and fortuitous in connection with the avowed and obvious effort of California

to rearrange her tax structure in respect to corporations on a legally permissible basis, and not only that, but upon a basis that would tend to remove existing inequalities in the tax system and result in the accomplishment of that purpose greatly to be desired, namely, the equalization of taxes as between banks and general business corporations.

In view of appellant's frequent references to the reports of the California Tax Commission and in view of the stress which appellant lays upon its contention that California's major purpose was to reach exempt income and lay a tax thereon, thereby accomplishing indirectly what it could not accomplish directly, we desire to make this final observation:

That no group of men, experts or otherwise, charged, as was the California Tax Commission, with the duty and responsibility of investigating the systems of revenue and taxation in force in California and in other states; of examining into any and all matters pertaining to the subjects of revenue and taxation in California; of making findings and conclusions based upon such investigations, and of making recommendations to the Legislature as to necessary changes in the existing system of taxation, including a report upon the matter of the relative burden of taxes borne by general property values and such property values as are taxed directly by the State under its existing system of taxation—no group with such responsibilities could claim to have performed the functions delegated to it unless it

devoted serious and conscientious attention to questions involved in the matter of tax-exempt property, the principles governing the immunity of certain property from taxation and the opportunities afforded the State to treat such tax-exempt property in a manner legally and constitutionally permissible. Any report submitted by such a group which did not deal fully and carefully with the subject of tax-exempt property would necessarily be incomplete and of little, if any, practical value to the members of the Legislature concerned with the subject of taxation. On the other hand, the value of the report to the Legislature and the value of the recommendations made by the investigating body would be in direct proportion to the thoroughness with which that body performed its duties.

Considering the great emergency existing in California, to which reference has already been made herein, it was all the more incumbent upon the California Tax Commission to make a very accurate and thorough investigation so that its conclusions and recommendations to the Legislature would be sound and might safely be made the basis of recommendations to the people for constitutional amendments or the basis for statutes to be enacted by the Legislature. Difficulties are not overcome by ignoring them and seeking short cuts. Rather, it may be said, difficulties will be increased and magnified by a deliberate refusal to recognize or treat with them. Therefore, in performing its duties, the California Tax Commis-

sion could not ignore the subject of tax exempts, and in treating of them in its report it did no more than any other intelligent commission would have done, and should have done, and had that commission done less it would have been subject to just criticism and condemnation. The fact, therefore, that it did its work in a thorough and comprehensive manner should not now be made the basis for the claim that California's motive in readjusting her tax system was ulterior or sinister or that there was, in fact, any motive other than as hereinabove explained a sincere and laudable desire to correct deficiencies in the tax policy of the State, to relieve the existing inequalities, and to bring about a fair, just and equitable distribution of the tax burden.

CONCLUSION

From this necessarily extended narrative of the history of the pertinent tax provisions of the California Constitution and of the Bank and Corporation Franchise Tax Act, and from this review and analysis of the authorities, the conclusion is irresistible that California did *not* inaugurate in 1928 a new tax system designed to accomplish by indirection that which it had not theretofore done or that which it was powerless theretofore to do, and that the relation of interest from tax exempts to the amount payable to California by banks and general corporations under the Bank and Corporation Franchise Tax Act is indeed "fortuitous and incidental" in the history and in the structure of that enactment.

The conclusion that the tax in question is not a property tax or a tax on tax-exempt bonds, or on the interest therefrom completely disposes of section 1¾ of Article XIII, for that section, as has been shown, applies only to property taxes and has never been intended or understood to affect other forms of taxes. Since section 1¾ of Article XIII deals with property taxes only and since the tax in question is not a property tax, it follows that neither section 16, Article I, of the State Constitution nor section 10, Article I, of the Federal Constitution is transgressed by section 16 of Article XIII and or by the Bank and Corporation Franchise Tax Act.

Appellant's argument that section 16 of Article XIII is retroactive is bound up in appellant's claim that there has been an impairment of the obligation of contract clause.

On the theory that section 1¾ of Article XIII comprehended or created an obligation to exempt corporations from the kind of tax provided for in the Bank and Corporation Franchise Tax Act (which, as we have said under Heading III hereof, we strenuously deny), it must be apparent that such obligation, being contrary to the present policy of the State and unsupported by adequate, if by any, consideration, was removed by the express provisions of section 16 of Article XIII.

We respectfully submit that the judgment of the Supreme Court of the State of California should be affirmed.

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Attorneys for Appellee.

FRANK L. GUERENA,
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EXHIBIT "A"

GOVERNOR'S LETTER TO LEGISLATORS

SACRAMENTO, August 16, 1928.

DEAR SENATOR _____:

I am calling the Legislature into special session, to convene Tuesday morning, September 4th, at 11 o'clock. The object of the session is the consideration of a constitutional amendment which may be submitted to the voters at the general election of next November. The submission of such an amendment clearly should not be delayed until the election two years hence.

I am advised that some amendment such as is proposed is unquestionably necessary to provide a legal method for the taxation of banks, our present method being invalid under the interpretation of the federal law in decisions of the United States Supreme Court. It is also proposed to provide a low rate of taxation for intangibles, two previous laws dealing with this problem having been adjudged unconstitutional by the Supreme Court of this state.

It goes without saying that no Governor likes to call a special session of the Legislature. Certainly none would have been called in this instance except for the absolute necessity of promptly putting our bank taxes on a sound and legal basis. I am informed by the Tax Commission that any delay in this matter will place in jeopardy no less than $22,000,000 of state revenue, probably all of which may be saved by immediate action.

Enclosed please find the formal call for a special session, together with an advance copy of my message to the Legislature, which I wish you would read very carefully as a continuation and amplification of this personal letter. I am also mailing by separate enclosure the report of the California Tax Commission of this subject, in order that you may determine for yourself whether there is any course of action possible other than the one embodied in their recommendation.

Yours very sincerely,

C. C. YOUNG, Governor.

ADVANCE MESSAGE TO THE LEGISLATURE

SACRAMENTO, August 16, 1928.

To the Members of the Senate and Assembly:

Though naturally reluctant to call you from your homes into a special session, I feel that under existing circumstances both you and the citizens of the state whom you represent could justly call me culpably negligent if I should fail to do so. The government of California is facing a most serious fiscal problem which involves its financial stability; and, after months of study by the Tax Commission, it is manifest that there is no way of solving this problem except by the adoption of a necessary constitutional amendment at next November's election.

The trouble has arisen through the discovery that our method of bank taxation adopted in 1910 has virtually become a dead letter on account of its conflict with federal law—a conflict made clear by recent decisions of the United States Supreme Court. Though this specifically applies to national banks, it practically applies to state banks as well, since it is easily seen that a taxed state banking system can not exist in competition with tax-free national banks, and that if national banks should escape taxation our state banks would speedily nationalize. The annual tax involved amounts to nearly $5,000,000, and the years involved run from 1926 to such time as a valid system of bank taxation is established.

At the outset it should be made clear that California state expenditures are being held down to the absolute minimum, just as they were two years ago, and that the work of the Tax Commission therefore consists largely in equalizing the burden of taxation rather than in finding new sources of revenue. At the same time, existing revenues are barely sufficient to meet these minimum expenditures; and, if we should lose any considerable portion of the $22,000,000 the Tax Commission finds involved in this bank-tax problem, we would have to make it up from some other source now presumably already bearing its full share of the tax burden. This is a thing which we must avoid at all hazards, and I am satisfied we can avoid it by sufficiently prompt and decisive action.

To make this subject as clear as possible I shall try to set forth: I, Why our system of bank taxation must be changed; II, How it may be changed; and III, Why it is imperative that it be changed now, rather than at the regular session next January.

I. Why Must the System Be Changed?

The law underlying national bank taxation may be found in section 5219 of the Federal Statutes, reading in part as follows:

> "Sec. 5219. The legislature of each state may determine and direct, subject to the provisions of this section, the manner and place of taxing all the shares of national banking associations located within its limits. The several states may (1) tax said shares, or (2) include dividends derived therefrom in the taxable income of an owner or holder thereof, or (3) tax such associations on their net income, or (4) according to or measured by their net income, provided the following conditions are complied with: * * *
>
> "In the case of a tax on shares the tax imposed shall not be at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of such state coming into competition with the business of national banks. * * *
>
> "In the case of a tax on or according to or measured by the net income of an association, * * * the rate shall not be higher than the rate assessed upon other financial corporations nor higher than the highest of the rates assessed by the taxing state upon mercantile, manufacturing and business corporations, doing business within its limits. * * *"

Thus it will be noted that there are two distinct ways by which a national bank may be taxed—a tax based upon the value of its shares and a tax based upon its net income. California in 1910 adopted the first method, then and for years afterward the only method permitted by the federal law as it then stood. In 1925 the legislature passed its 7 per cent intangibles law, and the Federal Supreme Court, in the so-called Wisconsin and Minnesota cases, through decisions handed down

in March, 1927, made it clear that such a law imposed upon the banks a greater tax "than is assessed upon other moneyed capital"; whereupon many of the banks paid their taxes under protest.

The Legislature in 1927 tried to correct this situation by fixing upon intangibles the same rate as had been fixed for banks; but it failed, in the opinion of a majority of the State Supreme Court, to provide for an equitable distribution of the proceeds of the tax on intangibles. Moreover, the fact was overlooked that by constitutional amendment California had exempted from taxation mortgages, which again might be construed to give to "other moneyed capital" a tax advantage over banks, and thus invalidate any bank tax based on shares. Inasmuch as it is obviously not advisable to repeal the tax exemption of mortgages, our constitutional amendment and laws for bank taxation have become dead letters and will continue to be dead letters unless the situation is met by new enactments. This would leave the national banks of the state without any state taxation whatever; while, as shown above, what is true for national banks must also practically be true for state banks.

II. How May the System Be Changed?

Our bank taxation based on shares having thus become invalid, we are thrown back upon the alternative method based on net income, and included as number (4) in the federal law by an amendment passed in 1926. This method, though only two years old, has already been adopted by other states, notably New York and Massachusetts. The California Tax Commission, after a most thorough study, has determined that no other method of bank taxation is practicable in this state.

By referring to the federal law as quoted above, it will be noted that in taxing banks on their net income the rate must not be higher than the rate upon the net income of other financial or business corporations—such corporations as are now paying the indefinite and unsatisfactory "state franchise tax"; though these corporations shall be permitted to deduct, as an offset to the state tax, the local taxes paid on personal property. It is important, therefore, to compute the rate on net income producing an equivalent of the amount paid by

banks under the old law, as well as the rate on net income equivalent to the amount paid by other corporations in franchise and personal property taxes.

A full and careful analysis shows that banks have been paying taxes equivalent on the average to 11.6 per cent of their net income, while other corporations of all classes have been paying taxes equivalent on the average to 4.4 per cent of their net income. However, these other corporations differ widely as to classes; for, while oil corporations, for instance, average 6.7 per cent, investment and finance corporations are paying on the average less than 1 per cent. Moreover, in the same class corporations differ widely in the weight of their taxes.

This shows a very great need for equalizing corporation taxes, and shows, also, that many corporations have been escaping without bearing their fair share of the tax burden. It is difficult to see, for instance, why banks should be taxed on the average 11.6 per cent—many of them over 25 per cent—of their net income, while certain other financial corporations are escaping with a tax of less than one-tenth of one per cent of their net income.

Inasmuch as the federal law provides that banks shall be taxed on their net incomes at no higher rate than that assessed against other corporations, what shall be the uniform rate fixed upon for both banks and these other corporations? Shall it be, for instance, 11.6 per cent, the average rate now paid by the banks? The answer is "No," partly because it will be too heavy a tax for many of these other corporations, and more especially because it will bring in more money than the state needs or has a right to expect. The purpose is to insure that the new bank tax together with the new corporation tax shall equal, but not exceed, the old bank tax plus the old corporation franchise tax.

The Tax Commission and its staff have figured that our present revenue will be maintained by a 4 per cent tax on the net income of both banks and other corporations, it being remembered that for these other corporations personal property taxes are in large measure to be deducted. If congress hereafter should change the federal law so as to provide a different or modified method for taxing banks, or different rates as between banks and other corporations, the proposed constitu-

tional amendment has been made sufficiently elastic to permit the legislature to act accordingly.

Let it be remembered that this 4 per cent rate is upon a net income rather than a gross income, and that it is a lower rate than that adopted by any other state, lower, for example, than the rate in Massachusetts or New York. Let it be noted that upon a corporation capital with a 6 per cent net income, a 4 per cent tax on that income is less than a one-fourth of one per cent tax on the capital—certainly a very small sum to pay for the privilege of doing a corporation business in this state. As a very prominent Los Angeles business man has just written to me: "Any corporation which is now paying only a nominal tax should be willing to pay as much tax as kindred corporations are paying, since the fact that they have escaped so far is no valid reason why they should continue to escape."

III. Why Should the System Be Changed Now?

Why can not this proposed amendment wait until next year's session of the Legislature when the entire tax question is being considered? I have been asked this question in good faith, and it is deserving of an answer. The main reason is that such delay would cost the state a very vast sum of money, probably all of which will be saved by action at the present time.

A constitutional amendment submitted now can be voted upon in November and at once go into effect, thus giving us immediately a valid system of bank taxation. A constitutional amendment submitted at the next regular session would not be voted upon for two years, thus leaving us without bank taxes for that length of time. Although many of the banks have protested or brought suit for the return of taxes paid in 1926, 1927, and 1928, their real interest is doubtless not in escaping from any just burden of taxes, but rather in securing a valid and stabilized method of bank taxation. Should such a method be at once adopted, there is little probability that the banks will proceed with their suits for a return of taxes already paid.

On the other hand, bankers have informed me that, if no new method of bank taxation is now adopted, they must refuse to pay any more taxes under the present invalid law, and that to be consistent they must follow up their suits for the return

of taxes already collected under the same invalid law. Thus by delaying we will not only lose all possibility of bank taxes for the next two years, but will involve the state in troublesome and expensive litigation to retain the bank taxes of the past two or three years. The Tax Commission estimates the amount in jeopardy to be more than $22,000,000, but feels that probably this entire amount can be saved by the submission and adoption of the necessary constitutional amendment at the approaching November election.

Incidentally, having abandoned the attempt to tax banks on the basis of shares, the way is now cleared for the adoption of a law for the taxation of intangibles, as called for by the voters at the general election of 1924. Accordingly a provision for the taxation of intangibles can be incorporated in this same constitutional amendment, and may be found in the tentative amendment at the end of the Tax Commission Report which has been placed in your hands. I would most strongly urge a study of this report, since it will enable you to determine whether our bank-tax revenues can be preserved by any other action than the one proposed.

IV. Conclusion.

I feel that enough has been said to show the necessity of a special legislative session at this time. The Tax Commission has spent months in trying to find some other remedy, but to no avail. The session has been postponed until after the primary election in order to remove it from the field of politics. It is not a political issue. It is not an administration issue. It is simply a financial crisis which has arisen without the fault of anyone, but which will be the fault of all of us if we do not take immediate and effective steps to settle it. I believe that none of us will seek to evade our manifest responsibility.

Very respectfully submitted.

C. C. YOUNG,
Governor.

EXHIBIT "B"

ARGUMENT IN FAVOR OF THE ADOPTION OF ASSEMBLY CONSTITUTIONAL AMENDMENT No. 1

This is an emergency measure, to save for the people some $22,000,000 in bank taxes, which otherwise the general taxpayer would have to make up. It will not increase total state taxes or revenues. It is submitted by unanimous vote of the Legislature to meet a crisis resulting from recent decisions of the United States Supreme Court.

These decisions practically nullify our present method of taxing banks and relieve banks from all taxes until that method is changed. This measure makes the only possible change, adopting the method already used in New York and other states, and meeting the requirement of federal law that national banks be taxed according to net income and at a rate no higher than is applied to other corporations. It is made sufficiently flexible to allow changes of rates or method whenever permitted by amendments in federal laws.

The amendment will accomplish the following results:

1. It will increase the bank taxes from nothing—their present status—to about $2,000,000 a year. Although lower than the necessarily abandoned bank tax revenue, the new tax is as high as can fairly be levied against other corporations whose tax burden legally must equal that of banks.

2. It will increase taxes about $2,000,000 a year on financial corporations, largely affiliated with banks and now escaping almost tax-free. Thus banks and their subsidiary corporations will together pay nearly as much as under the old illegal method—in some cases, actually more.

3. It will increase by about $1,000,000 a year the tax on certain other corporations, hitherto paying an insufficient, uncertain, and unsatisfactory franchise tax. Many of these, such as large newspaper corporations, are generously supporting this proposition as just and fair.

4. It will by these three increases protect the state against the loss threatened through federal court decisions and protect the general taxpayer against the burden of replacing this loss.

5. It will decrease the tax on a majority of the smaller corporations, now too often bearing a tax burden disproportionate to their ability to pay.

6. It will not affect the taxes of the general taxpayer. Banks and corporations will together pay just what they formerly paid before the bank tax was invalidated. Banks will continue to pay local taxes on their real estate, and corporations on both real and personal property. Without this amendment, banks would pay no state tax and their financial corporations little, leaving general taxpayers to make up the deficit.

7. It is therefore a new sort of tax law, preventing tax burdens from being increased instead of increasing them.

8. Finally, it alone makes possible a low but collectible tax on so-called "intangibles," as approved by the voters four years ago. This will not only attract to California new citizens and new capital, but will draw out of hiding an immense body of now concealed securities, and, by making them available for local taxation, lighten the tax burden on other property. This amendment specifically provides for such tax relief.

Accordingly, to save to the state a possible $22,000,000 in bank taxes which the general taxpayer would otherwise have to make up, to provide a valid bank tax for the future, to equalize corporation taxes, and to permit taxes on intangibles, *vote* "YES."

H. C. NELSON,
State Senator, First District.

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SUPREME COURT OF THE UNITED STATES.

No. 270.—October Term, 1931.

The Pacific Co., Ltd., Appellant,
vs.
Charles G. Johnson, State Treasurer of the State of California.

Appeal from the Supreme Court of the State of California.

[April 11, 1932.]

Mr. Justice Stone delivered the opinion of the Court.

This case is here on appeal, Jud. Code § 237, from a judgment of the Supreme Court of California, denying recovery of a tax paid by appellant, a California corporation, for the privilege of doing business within the state, and exacted under a statute[1] alleged to be in contravention of the contract clause, Art. I, § 10, of the Federal Constitution. 81 Cal. Dec. 519. The annual tax is, for domestic corporations, a specified percentage of the net income of the corporation for the next preceding fiscal or calendar year. By § 7 of the statute, net income is defined as "gross income" less certain allowed deductions, and § 6 provides that "gross income . . . includes . . . all interest received from federal, state, municipal or other bonds . . ." Section 1¾ of Art. XIII of the Constitution of California, adopted in 1902, provides that bonds issued by political subdivisions of the State and its municipalities "shall be free and exempt from taxation."

The State Franchise Tax Commissioner, in assessing appellant's franchise tax for the year 1928, included in its gross income interest derived from improvement district bonds, issued after the adoption of the quoted exemption provision of the Constitution, but before the constitutional amendment and the statute authorizing the tax. The present suit was brought to recover so much of the

[1]The California Bank and Corporation Franchise Tax Act, Cal. Stat. 1929, c. 13, p. 19, enacted pursuant to an amendment of the California Constitution, § 16, Art. XIII, adopted November 6, 1928, which authorized a tax on corporate franchises.

tax as results from the inclusion in the computation, of the interest received from the tax exempt bonds. Appellant insists that, under the exemption clause of the State Constitution, it acquired a contractual immunity from state taxation of the bonds or their income, and that the later statute, by authorizing the inclusion of the bond interest in the measure of the tax, in effect taxed the income and thus impaired the obligation of the contract.

If, as appellant argues, the exemption from taxation of the bonds is contractual and extends to the income derived from them, the question still remains whether the immunity is broad enough to secure freedom from taxation of a corporate franchise, to the extent that it is measured by tax exempt income. This Court, in answering that question, will, in the absence of applicable state decisions antedating the alleged impairment, be guided by generally accepted principles of construction which have been recognized and acted upon by this Court.

Until the article of the Constitution adopted in 1928, and the statute of 1929, there were no provisions in the Constitution and laws of California for taxing corporate franchises by the present method, and until this case no decision by any court of the state had determined whether the granted immunity extends to a tax upon corporate franchises because tax-free property or income is included in its measure. Long before the adoption of the constitutional exemption, there was a well-recognized distinction between a tax on the privilege of exercising the corporate franchise and a tax on corporate property or income, even though the former was measured by the latter, and tax immunity of the property or income was not deemed to extend to the franchise.

The power of a state to levy a franchise tax measured by net property or income including tax exempt bonds of the United States or their income was upheld by this Court in *Society for Savings* v. *Coite* (1868), 6 Wall. 594; *Provident Institution* v. *Massachusetts* (1868), 6 Wall. 632; *Home Insurance Co.* v. *New York* (1890), 134 U. S. 594. State laws taxing shareholders of national banks on the full net value of their shares, although the banks own tax exempt Federal securities, have also been consistently upheld. *Van Allen* v. *Assessors*, 3 Wall. 573; *Peoples National Bank* v. *Board of Equalization*, 260 U. S. 702; *Des Moines National Bank* v. *Fairweather*, 263 U. S. 103. Similarly Congress

may impose a tax on state banks measured by the average amount of their deposits, although deposits of state funds by state officers are included. *Manhattan Co.* v. *Blake,* 148 U. S. 412. The rule that a tax upon a franchise, measured by net income, including that from tax immune property, is not an infringement of the immunity, was reexamined and affirmed in *Flint* v. *Stone Tracy Co.,* 220 U. S. 107, which was accepted as authority in *Macallen Co.* v. *Massachusetts,* 279 U. S. 620, and followed in *Educational Films Corporation* v. *Ward,* 282 U. S. 379.

This distinction, so often and consistently reaffirmed, is but a recognition that the franchise, the privilege of doing business in corporate form, which is a legitimate subject of taxation, does not cease to be such because it is exercised in the acquisition and enjoyment of non-taxables. The distinction is one of substance, not of form, and has been so recently discussed in *Educational Films Corporation* v. *Ward* that it need not be elaborated here. It suffices to say that the tax immunity extended to property *qua* property does not embrace a special privilege, the corporate franchise, otherwise taxable, merely because the value of the corporate property or net income is included in an equable measure of the enjoyment of the privilege. The owner may enjoy his exempt property free of tax, but if he asks and receives from the state the benefit of a taxable privilege as the implement of that enjoyment, he must bear the burden of the tax which the state exacts as its price.

Petitioner lays no foundation for the assertion that the state court erroneously construed the grant of immunity as limited to taxes imposed on the bonds and their interest, and as not embracing taxes on the franchise measured by the net income of the taxpayer without discrimination as to its source. We cannot say that this construction, with which no judicial decision of the state conflicts, and which is supported by an unbroken line of decisions of this Court, some of them antedating the grant, is erroneous or that the later enactment of the challenged statute, in all respects consistent with it, impairs any contractual right which could be implied from the grant. Even if the construction were doubtful, the doubt, upon familiar principles, must be resolved in favor of the state. Grants of immunity from taxation, in derogation of a sovereign power of the state, are strictly construed. *Providence*

Bank v. *Billings*, 4 Pet. 514, 561; *The Delaware Railroad Tax Case*, 18 Wall. 206, 225-226; *Jefferson Branch Bank* v. *Skelly*, 1 Black 436, 447; *Charles River Bridge* v. *Warren Bridge*, 11 Pet. 420; *Yazoo & Mississippi Valley Ry.* v. *Thomas*, 132 U. S. 174; *Vicksburg & S. P. R. Co.* v. *Dennis*, 116 U. S. 665.

But appellant insists that even though the granted exemption is not broad enough to preclude, in every instance, the inclusion of tax exempt income in the measure of the tax, its inclusion by the present statute is not a casual incident to a scheme of taxation of franchises measured by all net income, such as was upheld in *Flint* v. *Stone Tracy Co., supra*, but is the result of a fully disclosed legislative purpose to subject to taxation the income of non-taxables, such as was deemed to invalidate the tax in *Miller* v. *Milwaukee*, 272 U. S. 713, and in *Macallen Co.* v. *Massachusetts, supra*. In support of this contention, petitioner points to the language of the taxing act, specifically including the income from tax exempt bonds in the measure of the tax, and to its legislative history.

The California Constitution was amended and the legislation taxing corporate franchises was enacted shortly after the decisions of this Court in *First National Bank* v. *Hartford*, 273 U. S. 548, and *Minnesota* v. *First National Bank of St. Paul*, 273 U. S. 561, which held that the requirement of R. S. § 5219, of an approximate equality of state taxation of national banks and of moneyed capital competing with them, comprehends the taxation not only of moneyed capital employed by state and private banks, but also that of other corporations in substantial competition with national banks. The State of California had previously imposed a tax on shareholders in banks, based on their proportionate share of the undivided profits, capital and surplus. Corporations other than banks, public utility, and insurance companies were taxed on the basis of their "corporate excess", in the computation of which non-taxable bonds were not included. In 1927 the California legislature created a commission to prepare a scheme of taxation which would secure the requisite equality. To attain this end the report of the Commission of August 10, 1928, (included in the final report of California Tax Commission of March 5, 1929, State Printing Office, Publication No. 63725, at p. 243, *et seq.*) recommended the adoption of the present corporate franchise tax as conforming to subdivision 4 of R. S. 5219, which permits the state

taxation of national banks "according to or measured by their net income." In the course of the report, specific reference is made to the belief of the Commission that in the computation of such a tax the income of non-taxable Federal bonds might be included in the measure of the tax, and it sufficiently appears from the report that the Commission was not unaware that income from bonds of the state would likewise be included by the proposed legislation and, indeed, that the desired equality of taxation of local corporations with that on national banks, measured by income, could not otherwise be secured. The adoption of the taxing act, as recommended by the Commission, may therefore be taken, as appellant contends, to evidence a definite and specific legislative purpose to levy a new type of franchise tax, measured by corporate net income, including the tax exempt income from Federal and state bonds.

The view that a tax, although levied on a taxable subject, may be deemed invalid because purposely devised to include a non-taxable subject in its measure, receives only a limited and qualified support from *Miller* v. *Milwaukee, supra.* There a state statute taxing corporate dividends was framed in such manner as to tax them only so far as they were derived from corporate income from tax exempt bonds of the United States. The taxing act thus, on its face, did more than exhibit an intention of the one sovereignty to include in the dividends taxed, those derived from income from a non-taxable instrumentality of the other, together with income from all other sources. That admittedly would have been permissible; see *Des Moines National Bank* v. *Fairweather, supra; Flint* v. *Stone Tracy Co., supra; Educational Films Corporation* v. *Ward, supra.* But it was the exclusion from the measure of the tax of all income except from Federal bonds which rendered the tax invalid.

Thus, in our dual system of government, action of the one government in the proper exercise of its sovereign powers, regarded as innocuous and permissible notwithstanding its incidental effects on the other, may become offensive and be deemed forbidden if it discriminates against the other. State taxes which, if non-discriminatory, would be upheld, even though they reach or affect those engaged in interstate commerce, are condemned if they discriminate against those so engaged, by placing on them heavier burdens than

those imposed on others within the state. *Welton* v. *Missouri*, 91 U. S. 275, with which compare *Wagner* v. *Covington*, 251 U. S. 95; *Darnell & Son Co.* v. *Memphis*, 208 U. S. 113; *Bethlehem Motors Corp.* v. *Flynt*, 256 U. S. 421. Cf. *Reymann Brewing Co.* v. *Brister*, 179 U. S. 445. See *General American Tank Car Corp.* v. *Day*, 270 U. S. 367, 372.

But the present case is not one of discrimination. There is no attempt, as in *Miller* v. *Milwaukee, supra*, to measure the tax by exempt income while excluding from the measure all taxable income. The state seeks to do only what its contract permits it to do, to measure the franchise tax by all the net income of the taxpayer. If the words "net income" in the taxing statute may rightly be taken to include income from tax exempt bonds, as they were in *Flint* v. *Stone Tracy Co., supra*, then there can be no tenable ground for saying that the addition of the words "income . . . includes . . . . all interest received from federal, state, municipal or other bonds," discloses any different purpose on the part of the legislature, or can have any different effect, or can more definitely infringe the exemption than did the tax upheld in *Flint* v. *Stone Tracy Co., supra*, or that in *Educational Films Corporation* v. *Ward, supra*.

But it is said that the ruling of this Court in *Macallen Co.* v. *Massachusetts, supra*, requires the condemnation of the present tax. There the Commonwealth, which had long imposed a tax on corporate franchises measured by taxable income of the corporation, amended its statutes so as to add the income from tax exempt bonds of the federal government to the measure of the tax. It was held that this change of taxation policy, embodied in the statute and "adopted as though it had been so declared in precise words for the very purpose of subjecting these securities *pro tanto* to the burden of the tax," was invalid. Thus the legislative abandonment of a policy which had previously discriminated in favor of tax exempt securities was treated as a discrimination against them, and the tax, although in fact non-discriminatory, was condemned as analogous to the discriminatory tax held invalid in the *Miller* case. See *Macallen Co.* v. *Massachusetts, supra*, pp. 630, 631.

But the State of California, in its legislation, has indulged in no reversal of policy so far as the measurement of the franchise tax is concerned and in no discrimination either in favor of or

against tax exempt income. The entire history of its legislation discloses only that it has sought, in good faith, to conform its scheme of taxation of corporations to a permitted method of taxing national banks, to avoid discrimination against the latter. It has effected its purpose by adopting, in a single legislative act, a new form of privilege tax on corporations measured by their net income, without any form of discrimination as to the sources of the income included in the measure, differing in this respect in no material way from the similar tax upheld in *Flint* v. *Stone Tracy Co.* and in *Educational Films Corporation* v. *Ward, supra.* We should hesitate to say that any action of the legislature or any purpose disclosed by a state commission could restrict the power of the state by constitutional amendment to authorize a tax which admittedly it could have authorized without them. In any case, the use of words in the statute and report, indicating what would otherwise have been implied, that "income" includes income from tax exempt bonds, could neither enlarge the exemption nor diminish the constitutional power of the state.

But we do not rest our decision upon any narrow distinction as to the precise form of words which may be employed in taxing statutes or the particular order in which its provisions are incorporated in the statute, whether by a single legislative act or by amendment or the addition of new provisions in successive reenactments. A taxing statute, like others, must be read as a whole, as it stands on the statute books at its applicable date, and the legislative purpose in enacting it must be taken, regardless of forms of words, to envisage the obvious consequences which flow from its operation. Since the mere intent of the legislature to do that which the Constitution permits cannot deprive legislation of its constitutional validity, and the purposeful choice by the state of a method of taxation which appellee's contract allows, cannot alter the terms of the contract, the present act must be judged by its operation rather than by the motives which inspired it. As it operates to measure the tax on the corporate franchise by the entire net income of the corporation, without any discrimination between income which is exempt and that which is not, there is no infringement of any constitutional immunity.

Affirmed.

SUPREME COURT OF THE UNITED STATES.

No. 270.—October Term, 1931.

The Pacific Co., Ltd., Appellant,
vs.
Charles G. Johnson, State Treasurer of the State of California.

Appeal from the Supreme Court of the State of California.

[April 11, 1932.]

Mr. Justice Sutherland, dissenting.

Mr. Justice Van Devanter, Mr. Justice Butler and I are unable to agree with the opinion and judgment just announced:

In *Miller* v. *Milwaukee*, 272 U. S. 713, speaking through Mr. Justice Holmes, this Court said:

"If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail even if but for its purpose or special operation it would be perfectly good. Under the laws of Wisconsin the income from the United States bonds may not be the only item exempted from the income tax on corporations, but it certainly is the most conspicuous instance of exemption at the present time. A result intelligently foreseen and offering the most obvious motive for an act that will bring it about, fairly may be taken to have been a purpose of the act. On that assumption the immunity of the national bonds is too important to allow any narrowing beyond what the Acts of Congress permit. We think it would be going too far to say that they allow an intentional interference that is only prevented from being direct by the artificial distinction between a corporation and its members. A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them, but it becomes a more serious attack upon their immunity when they are its obvious aim. In such a case the Court must consider the public welfare rather than the artifices contrived for private convenience and must look at the facts."

In *Macallen Co.* v. *Massachusetts*, 279 U. S. 620, the principle thus announced was applied to an act imposing a corporate excise

tax affecting the state's municipal securities in the same way as the California act affects the bonds here under consideration. These municipal securities were issued and acquired prior to the passage of the act, and when so issued and acquired were exempt from all forms of taxation by the express terms of a state statute. The situation in that respect is the same here, except that the exemption from taxation was made by the state Constitution instead of by statute. There, as here, the constitutionality of the act was challenged under the federal Constitution as impairing the obligation of contracts. We sustained the challenge, and pointed out that while a state was at liberty to impose a franchise tax upon a corporation with respect to the doing of its business, it could not tax the income of the corporation derived from non-taxable securities. We held that the effect of the taxing act was to repeal the prior statute and impose a burden upon the securities from which, by express provision of law, they had theretofore been free. In confirmation of this conclusion the report of a special commission appointed by the legislature to investigate the subject of taxation of banking institutions was cited and quoted. That report recommended the adoption of legislation which, by means of an excise upon the doing of business, would reach income from securities then exempt from taxation, either under federal or state law. The report received the consideration of the legislature, and, we thought it fair to suppose, constituted the basis for adopting the challenged act. We said (p. 633):

"The effect of the report is that non-taxable bonds nevertheless should be subjected to the burden of the tax; and, since that could not be imposed directly, the clear intimation is that it be imposed indirectly through the medium of the so-called 'excise'".

We therefore concluded that the act manifested a change of policy adopted with the aim and for the purpose of subjecting the tax-exempt securities, *pro tanto*, to the burden of the tax, and, therefore, impaired "the obligation of the statutory contract of the state by which such bonds were made exempt from state taxation."

In the present case the aim and purpose of the California legislature to reach the same illegal result by indirection is no less clear. Here, as in Massachusetts, the State Tax Commission investigated the subject and made a special report to the Governor for submission to the legislature. In the course of the report the com-

mission expressed the opinion that the only practicable method of securing a substantial revenue from the banks was to tax them "according to or measured by net income." This was designated its "fourth method." As distinguished from the "third method" suggested, the commission said that such a tax "is designed to include within the scope of its application certain types of income which may not legally be reached by a pure net income tax—such as interest on tax-exempt government bonds. . . . The third method may be discarded in favor of the fourth, because under the fourth everything can be accomplished which may be gained by proceeding under the third, and presumably more besides, viz, *the inclusion, if desired, of tax-exempt interest in the base.*"

Later in its report, under the heading "Importance of Including Tax-exempt Interest in Base," the commission, after calling attention to the *Macallen* case, then pending but not decided, said:

"In the case of corporations other than banks, the point is not of vital importance. *But the banks hold such large quantities of these tax-exempt bonds that the effect of a decision holding that the state may not include them in the base would be very serious indeed.*"

There is more in the report to like effect.

In January, 1929, the two houses of the state legislature gave public hearings on the subject. Among others, Professor Haig of Columbia University, who had served as technical advisor to the commission, appeared and made a statement, in the course of which, in explanation of bills then pending, he said:

"Now, as to the definition of net income. You will find this material presented in section 6 and following. In the first place, the definition of income is broad, in one respect, in that it does attempt *to include within the scope of the base used as the measure of the tax income received from tax-exempt securities*—that is, government bonds and so on. . . . Interest from tax-exempt bonds is an exceedingly important item in a tax which is applied to banks. The definition is broad, in that it does include this tax-exempt interest in the base which is used as a measure of the value of the franchise."

The act here in question, which resulted from, and evidently was based upon, the report of the Commission and the statements of its advisor, provides in express terms:

"Sec. 6. The term 'gross income,' as herein used, includes . . . all interest received from federal, state, municipal or other bonds, . . .

"Sec. 7. The term 'net income,' as herein used, means the gross income less the deductions allowed." (No deduction, however, is allowed for interest received from federal, state, municipal or other tax-exempt bonds.)

The foregoing is so plain that comment or elucidation would seem unnecessary. The bare recital of the facts, in our opinion, shows how unreasonable it is to hold that the aim and purpose of the legislation was not, by indirection, to impose a tax upon income derived from tax-exempt securities which, constitutionally, could not be imposed directly. To say that the effect of the tax upon the tax-exempt bonds is "casual" and not its "obvious aim," (*Miller* v. *Milwaukee, supra*), is simply to presume upon our credulity. We think there is no escape from the conclusion that if the *Miller* and *Macallen* cases were followed the legislation here under review would be condemned. To base a distinction of these cases from the pending case upon differences so lacking in substance as to be in effect no differences at all, simply adds to the confusion already too great in this field of taxation.

The California franchise tax, in its application to the bonds here under consideration, is peculiarly indefensible. When these bonds were issued and acquired they were, by express constitutional provision, made "free and exempt from taxation." Upon the faith of that provision the bonds were bought. The fact that they were to be free from taxation must have resulted in the receipt of a larger price than otherwise would have been the case. The difference between the sum paid and what would have been paid but for the exemption was, in a very real sense, money taken from the purchaser in exchange for the tax immunity—as though future taxes had been anticipated by an immediate payment of the amount, computed on the basis of their present worth. By every principle of fair construction, the purchaser having paid for this immunity became entitled to hold the bonds and income therefrom free from any future taxation, the burden of which, however disguised, would fall, and was meant to fall, upon them. Otherwise the contractual obligation is a mere sham, signifying nothing. It is not denied, as we understand, that if the state had laid the tax directly upon the income derived from the bonds an unconstitutional impairment of the obligation would have resulted. And, in this respect, it is hard to see any substantial difference between a tax laid directly upon the income and one laid

upon a privilege but measured by, and definitely intended to reach, such income. Undoubtedly, a state has the power to impose a franchise tax for the privilege of doing business as a corporation within the state and also to measure that tax by the amount of income received; but in every case where this court has sustained the validity of such a tax, when measured in part by non-taxable income, it has done so upon the view, implicit or express, that the latter in fact and reality was not the subject sought to be taxed, and that any burden thereby put upon it was casual and incidental.

A tax in form laid upon A but measured by B at once suggests that B was in reality the thing aimed at; and if inquiry discloses, as it does here, that such is the fact the tax, assuming B to be non-taxable, should not be allowed to stand in the face of the settled principle that what cannot be done directly because of constitutional restriction cannot be done indirectly by legislation designed to reach the same end. *Fairbank* v. *United States*, 181 U. S. 283, 294, 300.

It is important for the states and their municipalities to obtain revenue; but, in doing so, it is also important that they shall not dishonor their promises. The moral duty of a state to keep its word, in spirit as well as in letter, is no less than that of an individual; and courts which condemn direct impairment by legislation of contractual obligations should not be over-ready to approve the adoption of circuitous and delusive means, which in form avoid but in fact accomplish the same unconstitutional result.